



MORTGAGE BANKING ALERT

CALIFORNIA ENACTS PREDATORY LENDING STATUTE

Last August, we provided you with an alert relating to California Assembly Bill 489, a predatory lending proposal that would have been perhaps the most far reaching anti-predatory lending law enacted in the United States. While the bill that was ultimately signed into law was substantially revamped (and is in many respects similar to the Homeowners Equity Protection Act (HOEPA)), and was itself later amended by California Assembly Bill 344, California has now joined the growing national movement to restrict certain loan activities at the state level. Comparisons of the new law to HOEPA will be set forth in footnotes where appropriate. The new law applies to consumer loans for which applications are received on or after July 1, 2002. The new law may be found at Sections 4970-4979.8 of the California Financial Code.

The new law imposes various requirements on “covered loans.” Under the new law, “covered loans” are defined as consumer loans secured by one-to-four unit residential properties used or intended to be used or occupied as the principal dwelling of the consumer.¹ The law excludes from the definition of consumer loans reverse mortgages, open-end lines of credit, consumer credit transactions secured by rental property or second homes, and bridge loans with a maturity of less than one year (if the purpose of the bridge loan is the acquisition or construction of a dwelling intended to become the consumer’s principal dwelling).

A covered loan is a consumer loan in which the original principal balance of the loan does not exceed \$250,000,² and where one of the following conditions are met: (1) The APR at consummation exceeds by more than eight percentage points³ the yield on Treasury securities having a comparable maturity,⁴ or (2) the total points and fees payable by the consumer at or before closing for a mortgage or deed of trust will exceed 6 percent of the total loan amount.⁵





The \$250,000 amount will be adjusted every five years in accordance with the California Consumer Price Index.

“Points and fees” will include: (1) all items required to be disclosed as finance charges under Sections 226.4(a) and 226.4(b) of Regulation Z (including the commentary thereto) except interest; (2) all compensation and fees paid to mortgage brokers in connection with the loan transaction; and (3) all items listed in Section 226.4(c)(7) of Regulation Z (real estate-related fees), but only if the person originating the covered loan receives direct compensation in connection with the charge.⁶

The new law contains a lengthy list of prohibitions applicable to covered loans, including the following:

1. A covered loan cannot include a prepayment fee that extends beyond the first three years of the loan. During the first three years, a covered loan may include a prepayment fee if the originator of the covered loan has offered the consumer a choice of another product without a prepayment fee, and has disclosed in writing to the consumer at least three business days prior to loan consummation the terms of the prepayment fee and the rates, points and fees that would be available to the consumer for accepting a covered loan without a prepayment fee. The prepayment fee cannot exceed six months’ advance interest on the amount prepaid in any 12-month period in excess of 20 percent of the original principal amount. The prepayment fee may not be imposed if the covered loan is accelerated as a result of a default.⁷
2. The person who originates the covered loan may not finance a prepayment fee through a new loan originated by the same person.⁸
3. A covered loan with a term of five years or less generally may not provide for a balloon payment at maturity.⁹
4. A covered loan may not contain a provision for negative amortization unless the covered loan is a first mortgage loan and the licensed person discloses to the consumer that the loan contains a negative amortization provision that may add principal to the balance of the loan.¹⁰
5. A covered loan may not include terms under which periodic payments required under the loan are consolidated and paid in advance from the loan proceeds.¹¹
6. A covered loan may not contain a default rate of interest.¹²
7. A person who originates covered loans may not make or arrange a covered loan unless at the time the loan is consummated, the person reasonably believes the consumer will be able to make the scheduled payments to repay the obligation based upon a consideration of their current and expected income, current obligations, employment status, and other financial resources other than



the consumer's equity in the dwelling that secures the loan.¹³ In the case of a covered loan that is structured to increase to a specific designated rate, stated as a number or formula, at a specific predetermined date not exceeding 37 months from the date of application, the evaluation must be based upon the fully indexed rate of the loan calculated at the time of application. The consumer shall be presumed to be able to make the scheduled payments to repay the loan if, at the time the loan is consummated, the consumer's total monthly debts, including loan payments, do not exceed 55 percent of the consumer's monthly gross income. For "stated income loans," the lender's reasonable belief may be based on the income stated by the consumer, and other information in the possession of the person originating the loan after the solicitation of all information that the person customarily solicits in connection with stated income loans.¹⁴

8. A person who originates a covered loan may not pay a contractor under a home-improvement contract from the proceeds of a covered loan, other than by an instrument payable to the consumer or jointly to the consumer and the contractor or, at the election of the consumer, to a third-party escrow agent.¹⁵ Signed, dated completion certificates for completed work must be presented to the originator by the consumer before any payments may be made.¹⁶
9. It is unlawful for a person who originates a covered loan to recommend or encourage a consumer to default on an existing consumer loan or other debt in connection with the solicitation or making of a covered loan that refinances all or any portion of the existing consumer loan or debt.¹⁷
10. A covered loan may not contain a call provision that permits the lender, in its sole discretion, to accelerate the indebtedness, except in accordance with the loan documents as a result of the consumer's default, pursuant to a due-on-sale clause, or due to fraud or material misrepresentation by a consumer in connection with the loan or the value of the security for the loan.¹⁸
11. A licensed person may not refinance or arrange for the refinancing of a consumer loan such that the new loan is a covered loan that is made for the purpose of refinancing, debt consolidation or cash out, that does not result in an identifiable benefit to the consumer, considering the consumer's stated purpose for seeking the loan, fees, interest rates, finance charges, and points.¹⁹
12. A disclosure written in 12-point font or larger containing mandated text and entitled "CONSUMER CAUTION AND HOME OWNERSHIP COUNSELING NOTICE" must be provided to the consumer no later than three business days prior to signing the loan documents for the covered loan.²⁰
13. A person who originates a covered loan may not steer, counsel or direct any prospective consumer to accept a loan product with a risk grade less favorable than the risk grade that the consumer would qualify for based on that person's then-current underwriting guidelines. A broker who originates a covered loan may not steer, counsel or direct any prospective consumer to accept a loan



product at a higher cost than that for which the consumer could qualify based on the loan products offered by the persons with whom the broker regularly does business.²¹

14. A person who originates a covered loan may not avoid the application of the new laws by structuring a loan transaction as an open-end credit plan for the purpose of evading the provisions of the new law if the loan would have been a covered loan had it been structured as a closed end loan; or dividing any loan transaction into separate parts for the purpose of evading the provisions of the new law.²²

15. A person who originates a consumer loan (remember that this is broader than a covered loan, and generally includes all closed-end mortgage loans secured by the borrower's principal residence) may not finance into a consumer loan transaction or finance to the same borrower within 30 days of a consumer loan transaction any credit life, credit disability, credit property or credit unemployment insurance premiums, or any debt cancellation or suspension agreement or contract fees (except such premiums or fees calculated and paid on a monthly basis). Private mortgage insurance or a contract issued by a government agency to insure the lender against loss caused by a mortgagor's default is permitted.²³

16. A person who originates covered loans may not make a covered loan that finances points and fees in excess of \$1,000 or 6 percent of the original principal balance exclusive of points and fees, whichever is greater.²⁴

17. A person who originates a covered loan may not engage in a fraud.²⁵

The statute specifically provides that a person who provides brokerage services to a borrower in a covered loan transaction is a fiduciary of the borrower.²⁶

If a compliance failure that is not willful or intentional and results from a bona fide error (e.g., clerical, calculation, computer malfunction and programming and printing errors), and that occurs notwithstanding the maintenance of procedures reasonably adopted to avoid those errors, is corrected no later than 45 days after receipt of the complaint or discovery of the error, the originator of the covered loan in question will avoid liability for the failure. An originator may be jointly liable for a violation of these provisions by a broker if the originator knew of and showed reckless disregard for the broker's violation.

The Department of Real Estate (for brokers), the Department of Corporations (for licensed residential mortgage lenders and licensed finance lenders and brokers) and the Department of Financial Institutions (for commercial and industrial banks and savings associations and credit unions organized in California) are given specific enforcement authority. Any person who willfully and knowingly violates any provision of the new law shall be liable for a civil penalty of not more than \$25,000 for each violation, which shall be assessed and recovered in a civil action brought in the name of the people of the State of California by



the licensing agency in any court of competent jurisdiction. The licensing agency may also include a claim for relief in addition to the penalties, including a claim for restitution or disgorgement. The Attorney General is given specific enforcement authority. A failure to comply gives a consumer a right to actual damages plus attorney's fees and costs. A willful and knowing violation gives the consumer the right to the greater of actual damages or \$15,000, plus attorney's fees and costs. A judge may also award punitive damages in a consumer action.

¹ The new law is broader than HOEPA, which does not apply to residential mortgage transactions.

² HOEPA does not contain an amount limitation, so in that respect, the new law is more limiting than HOEPA.

³ HOEPA currently uses 10 percentage points, which would cover fewer loans than the new law, but effective October 1, 2002, the HOEPA threshold will become eight percentage points for first lien loans, but remain at 10 percentage points for junior lien loans.

⁴ The federal government recently eliminated 30-year Treasury securities. Lenders must now use the yield on 20-year Treasury securities in determining which of their loans are subject to HOEPA. See our alert at www.akingump.com, dated April 2002 for further information in this regard.

⁵ HOEPA uses the greater of 8 percent of the total loan amount or \$400, but this percentage may also be reduced shortly, further expanding the scope of HOEPA's coverage.

⁶ This definition is very similar to that contained in Section 226.32(b) of Regulation Z, except that fees paid to affiliates under Section 226.4(c)(7) of Regulation Z are not included in the new law's definition.

⁷ The criteria for permitting prepayment fees under HOEPA are completely different than in the new law. See Section 226.32(d)(7) of Regulation Z.

⁸ This limitation is similar to that set forth in Section 226.32(d)(7) of Regulation Z, except that Regulation Z prohibits the prepayment fee from being refinanced by the creditor or an affiliate of the creditor.

⁹ The provision in the new law is identical to that in Regulation Z, except that the new law does provide for limited exceptions.

¹⁰ HOEPA prohibits negative amortization without any exceptions, but as pointed out in footnote 1, residential mortgage

transactions are excluded from coverage by HOEPA, but not by the new California law. Therefore, a residential mortgage transaction that features negative amortization will not be prohibited by HOEPA, but may be prohibited by the new California law.

¹¹ HOEPA permits up to two periodic payments required under the loan to be consolidated and paid in advance from the loan proceeds.

¹² This is essentially identical to HOEPA, except that Regulation Z also contains a provision that governs rebates of interest due upon acceleration of the loan.

¹³ The new law adds the last clause, but is otherwise identical to HOEPA.

¹⁴ HOEPA does not contain a comparable provision.

¹⁵ The new law and HOEPA are identical.

¹⁶ HOEPA does not contain a comparable provision.

¹⁷ HOEPA does not contain a comparable provision.

¹⁸ HOEPA does not contain a comparable provision.

¹⁹ HOEPA does not contain a comparable provision.

²⁰ HOEPA requires a much more limited disclosure, but also requires that the creditor disclose the annual percentage rate, the amount of the regular monthly (or other periodic) payment and, for variable-rate transactions, a statement that the interest rate and monthly payment may increase, and the amount of the single maximum monthly payment, based on the maximum interest rate that may be imposed during the term of the obligation.

²¹ HOEPA does not contain a comparable provision.

²² HOEPA does not contain a comparable provision.

²³ HOEPA does not contain a comparable provision.

²⁴ HOEPA does not contain a comparable provision.

²⁵ HOEPA does not contain a comparable provision.

²⁶ HOEPA does not contain a comparable provision.

CONTACT INFORMATION

Attorneys at Akin Gump have had a long history of representing a variety of institutions in the mortgage lending industry. If you wish to discuss the impact of this law on your organization, please contact:

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