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CLIENT MEMORANDUM

TO: Clients and Friends of the Firm

FROM: Al Alsup

DATE: May 23, 2008

RE: Overview of Bold New Truth in Lending and RESPA Regulations Proposed by Federal Agencies that would Fundamentally Change How Home Mortgage Loans are Originated, Processed, Underwritten and Closed and how Fees to Mortgage Brokers and Other Settlement Service Providers are Paid and Disclosed.

Introduction: Bad Facts Make for Bad Law

It should come as no surprise to those of us in the mortgage lending industry that there would be a price to pay for the subprime mortgage debacle besides projected billions of dollars in industry losses. We soon can expect Congress and federal regulatory agencies to impose burdensome new regulations on the industry that target abusive lending practices widely criticized as an underlying cause of the national housing crisis and record home foreclosures. Bad facts are said to make for bad law. A dozen bills are now brewing in Congress to rescue housing and to tighten the noose of housing finance regulation. And federal regulatory agencies have awakened to increasing pressure to rectify their past sins of supposed lax oversight. Now, on cue, the Federal Reserve Board of Governors (FRB) and the Department of Housing and Urban Development (HUD), each pursuing its own vision of how consumers should best be protected from high costs and abusive practices in the home mortgage origination process, have separately proposed bold new rulemaking to amend regulations to the federal Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA), respectively, that, if adopted as Final Rules, will fundamentally change the way that home mortgage loans subject to these statutes must be originated, processed, underwritten and closed nationwide.

Overview of the FRB Proposed Rule

The FRB Proposed Rule would amend Regulation Z, which interprets and implements TILA and the Home Ownership and Equity Protection Act (HOEPA), to impose seven new restrictions on, or requirements for, the mortgage lending and servicing process that are intended to protect consumers from unfair, deceptive, and abusive practices by loan originators and service providers. Some restrictions and requirements would apply to all home mortgage loans secured by a consumer's principal dwelling. Others would apply only to higher priced mortgage loans, including so-called "high-cost, high-rate" HOEPA loans (or sometimes called Section 32 loans) with which all in the industry are familiar and a new category of "higher priced mortgage loans" (HPMLs), which would be defined in part as closed-end, mortgage loans secured by the consumer's principal dwelling having an annual percentage rate (APR) that exceeds the rate of comparable Treasury Securities by three or more percentage points (for first liens) or five percentage points (for subordinate liens). Comparable Treasury Securities are defined and the manner of determining their yield for this purpose are set out in these regulations. HPMLs undoubtedly would comprise all so-called "subprime" and at least some "Alt. A" home loans. An apparent misnomer, the HPML "higher priced mortgage loans" actually would have lower rates than so-called "high priced" HOEPA loans. These two categories of regulations of higher priced mortgage loans could be thought of as "HOEPA" and "HOEPA-Lite".

Under the FRB Proposed Rule, all consumer-purpose, closed-end loans secured by a consumer's principal dwelling would be subject to three new consumer protections:

- *Required Broker Services Agreements*. Creditors would be prohibited from making any payment to a mortgage broker unless the mortgage broker has first entered into a written agreement with the consumer that includes a clear and conspicuous statement of the maximum dollar amount of compensation the mortgage broker will receive and retain from all sources, including from the consumer and any other source, such as the lender. Such an agreement also would be required to contain clear and conspicuous statements that (i) the consumer will effectively pay the entire amount of all such compensation, even if all or part of the compensation is paid directly by the creditor, because the creditor will recover any payments it may make to the broker through a higher interest rate charged the consumer; and (ii) that such payments from a creditor can influence the broker to offer loan products or terms that are not in the consumer's best interest or are not the most favorable terms obtainable. A creditor's payment to a mortgage broker could not exceed the total compensation amount stipulated in such a written agreement (reduced by any amount paid directly to the broker by the consumer or from any other source). The written agreement would be required to be entered into before the consumer pays a fee to the mortgage broker or any other person in connection with the mortgage transaction or submits a written application to the broker for the loan transaction, whichever is earlier.

- *Prohibited Coercion of Appraiser.* Creditors and mortgage brokers, and their affiliates, would be prohibited from directly, or indirectly, coercing, influencing, or otherwise encouraging an appraiser to misstate or misrepresent the value of a principal dwelling securing the loan. Prohibited actions would include (i) implying that current or future engagements of the appraiser are conditioned upon reporting of appraised values at particular target amounts, (ii) failing to compensate the appraiser unless the appraised value reported is at or above a particular amount, or (iii) conditioning compensation to the appraiser on actual loan closings. However, creditors and mortgage brokers would not be prohibited from such actions as (i) asking an appraiser to consider comparable properties or to consider additional information about the appraised property; (ii) requesting the appraiser to provide additional information about the basis of the valuation; (iii) requesting the appraiser correct factual errors in the appraisal report; (iv) obtaining multiple appraisals of a property (so long as the creditor or mortgage broker adhere to a policy of selecting the most reliable appraisal, rather than just the appraisal that states the highest value); or (v) withholding compensation to the appraiser for breach of contract or substandard performance, terminating a relationship with an appraiser for violations of state or federal law or ethical standards, or taking other action affecting the appraiser that is permitted or required by applicable state or federal law or regulations. Any creditor who knows or has reason to know at or before a loan closing of a violation of these anti-coercion regulations must not extend credit based upon such an appraisal (unless the creditor documents that it has acted with reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the value of the appraised property).

- *Prohibited Servicing Practices.* Mortgage *servicers* (the term having the same meaning as defined in Reg. X, §3500.2) would be prohibited from engaging in certain servicing practices, including (i) failing to credit a payment to the consumer's loan account as of the date of receipt (except when a delay in crediting the payment does not result in any charge to the consumer or in reporting of negative information to a consumer credit reporting agency or when payments in some cases are accepted that do not conform to written requirements of the lender and the payment must be credited within five days of receipt); (ii) imposing a late charge in connection with the receipt of a payment when the only delinquency is attributable to failing to include payment for a late charge assessed on an earlier payment, and the current payment is otherwise a full payment made on or before its due date or within an applicable grace period (i.e., "pyramiding" of late fees); (iii) failing to provide, within a reasonable time after a request for it by a consumer, a schedule of all specific fees and charges that the servicer may impose on the consumer in connection with servicing of the consumer's account (including a dollar amount and an explanation of each such fee and the circumstances in which it may be imposed); and (iv) failing to provide, within a reasonable time after a request for it by a consumer (or a person acting on behalf of a consumer), an accurate "payoff statement" setting out the total outstanding balance of the consumer's loan obligation that would be required to satisfy the obligation in full as of a specified date.

Beyond these restrictions applicable to all such loans, so-called higher priced mortgage loans, or HPMLs, would be subject to four additional new consumer protections:

- *Prohibited Lending without Regard to Repayment Ability.* Creditors would be prohibited from engaging in a pattern or practice of extending credit for HOEPA and HPML loans (except temporary or "bridge" loans with a term of 12 months, or less) to consumers based on the value of the consumer's collateral without regard to the borrowers' ability to repay the loan from sources other than the collateral itself, including the consumer's current and reasonably expected income, current and reasonably expected obligations, employment, and assets other than the collateral. Violation of this prohibition would be presumed if the creditor engages in a pattern and practice of failing to (i) verify and document consumers' repayment ability under new regulations for verification of income and assets when approving an extension of credit by checking federal tax returns, Form W-2s, bank records, or other third party documents that provide reasonably reliable evidence of the consumer's income or assets; (ii) consider consumers' ability to make loan payments based on the contract interest rate or, if the interest rate may increase after consummation, based on the greater of the initial contract interest rate or the fully indexed interest rate (i.e., index effective as of the date of consummation + margin) for variable rate loans or the highest possible interest rate within the first seven years of the term for step-rate loans; (iii) consider consumers' ability to make loan payments based on a fully amortizing payment that includes, as applicable, expected property taxes, homeowners' association dues, property and liability insurance premiums, private mortgage insurance and other mortgage related premiums; (iv) consider the ratio of consumers' income to total debt obligations; and (v) consider the income consumers will have available after paying their debt obligations. Nevertheless, a creditor would not be found to violate this prohibition if it has a reasonable basis to believe consumers will be able to make loan payments for at least seven years after loan consummation considering these and other factors relevant to determining repayment ability.

- *Required Verification of Income and Assets Relied on in Underwriting.* Creditors would be required to verify borrowers' income and assets relied upon in underwriting the loan, thereby prohibiting so-called "stated income" and "No Docs" loans. Specifically, a creditor, when approving an extension of credit, would be prohibited from relying on stated amounts of income, including expected income, or assets unless the creditor verifies such amounts by inspection of the consumer's Internal Revenue Service federal tax returns and Form W-2, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer's income and assets. However, a 'no harm, no foul' rule would provide that a creditor is not in violation of this prohibition if the amounts of income and assets that the creditor relied upon in approving the loan transaction are not materially greater than the amounts of the consumer's income or assets that the creditor could have verified in this manner at the time the loan was consummated.

- *Restrictions on Prepayment Penalties.* Creditors would be permitted to charge a prepayment penalty under identical conditions applicable to HOEPA loans. As proposed, both HOEPA and HPML loans would be permitted to provide for a prepayment penalty if (i) the penalty is otherwise permitted by state or other applicable law; (ii) prepayment is not made from a refinancing by the same creditor, or its affiliate; (iii) the period during which the prepayment penalty may be imposed does not exceed five years from the date of loan closing; (iv) the prepayment penalty period ends at least 60 days prior to the first date, if any, that the monthly payment of principal and interest may increase under terms of the loan; and (v) the borrower's total monthly debt payments (including amounts owed under the loan) do not exceed 50% of the borrowers' gross monthly income (i.e., a 50% debt-to-income ratio) as of the date of loan closing, as verified under the new procedures requiring review of federal tax returns, Form W-2s, payroll receipts, bank records, or other third-party documents that provide reasonably reliable evidence of the borrower's income.

- *Mandatory Escrow Accounts.* Creditors at or before loan closing of a first-lien HPML loan would be required to establish and maintain an *escrow account* (the term having the same meaning as defined in Reg. X, §3500.17(b)) to collect reserves for the payment of property taxes, property insurance, and liability insurance (and, if applicable, required private mortgage insurance or other mortgage related insurance). After the first loan year, the creditor would be permitted to cancel the required escrow account only if the creditor receives a dated written request from the consumer to cancel the escrow account that is received by the creditor no earlier than twelve months after loan consummation.

Moreover, all mortgage loans (i.e., not just higher cost mortgage loans) subject to TILA and secured by a dwelling (i.e., not just a "principal dwelling"), both open-end and closed-end credits, would be subject to:

- *New Advertising Regulations.* Extensive advertising regulations would be imposed to assure that advertisements for credit provide accurate and balanced information about rates, monthly payments, and other loan features in a clear and conspicuous manner and that several deceptive and or misleading advertising practices are banned, including, for example, describing a loan as a "fixed rate" mortgage when in fact the rate can increase after closing (e.g., so-called "2-28 and 3-27 hybrid ARM" loans).

  These advertising regulations would apply principally to newspaper and other print advertisements, including brochures and other promotional materials, and alternative regulations would apply to television and radio advertisements:

  1. *Disclosures of Rates and Payments in Print Advertisements*. If an advertisement for credit secured by a dwelling (other than television or radio advertisements) states a simple rate of interest when more than one simple annual rate of interest will apply over the term of the advertised loan, the advertisement would be required to disclose in a clear and conspicuous manner each simple interest rate that will apply (based on a reasonably current index plus margin if a variable rate transaction), the period of time during which each such rate will apply, and the annual percentage rate (APR) for the loan. If the advertisement states the amount of any payment, it would be required to disclose the amount of each payment that will apply over the term of the loan, including any balloon payment, the period of time during which each such payment will apply, and the fact that the payments do not include escrow amounts for property taxes and insurance premiums, if applicable, and that the payment accordingly will be greater. These additional "trigger" disclosures would be required to be disclosed with equal prominence and in close proximity to any such advertised rate or payment. However, these disclosure requirements would not apply to the envelope in which an application or solicitation is mailed or to a banner or pop-up advertisement linked to an application or solicitation provided electronically.

2. *Alternative Disclosures for Television or Radio Advertisements.* An advertisement made through television or radio stating orally any of the triggering terms requiring additional disclosures may comply with those requirements by either (i) stating orally each of the required additional disclosures at a speed and volume sufficient for a consumer to hear and comprehend them; or (ii) stating orally the annual percentage rate (APR) and, if applicable, that the rate may increase after loan consummation at a speed and volume sufficient for a consumer to hear and comprehend them, and listing a toll-free telephone number along with a reference that such number may be used by consumers to obtain additional cost information.

3. *Disclosure Regarding Tax Implications.* If an advertisement distributed in paper form or through the Internet (but not through radio or television) is for a loan secured by the consumer's principal dwelling that may, by its terms, exceed the fair market value of the dwelling (e.g., loans with negative amortization), the advertisement would be required to clearly and conspicuously state that (i) interest on any portion of the loan that exceeds the fair market value of the dwelling is not tax deductible for federal income tax purposes; and (ii) the consumer should consult a tax adviser for further information regarding the deductibility of interest and charges.

4. *Prohibited Acts or Practices in Advertisements.* The following acts or practices are expressly prohibited in advertisements for credit secured by a dwelling:

   - *Misleading advertising of "fixed" rates and payments.* Using the word "fixed" to refer to rates, payments, or a credit transaction in an advertisement for a variable rate transaction where the advertised rate or payment may increase unless certain qualifying statements required under the rule are used, such as (i) using the phrase "adjustable rate mortgage" or "variable rate mortgage" in the advertisement before the first use of the word "fixed" that is at least as conspicuous as every use of the word "fixed" in the advertisement, and (ii) accompanying each use of the word "fixed" with an equally prominent and closely proximate statement of the time period for which the rate or payment is fixed and the fact that the rate may vary and the payment increase after that period.

   - *Misleading Comparisons in Advertisements.* Making any comparison in an advertisement between an actual or hypothetical consumer's current credit payments or rates and any payment or simple annual rate that will be available under the advertised loan program for less than the term of the loan unless the advertisement includes (i) an equally prominent, closely proximate comparison to all applicable payments or rates that will apply over the term of the loan and the period of time for which each such payment or rate applies, and (ii) a prominent statement in close proximity to the disclosure of such payments that the advertised payments do not include amounts reserved for property taxes and insurance, if applicable. If such an advertisement is for a variable rate loan transaction and the advertised payment or simple annual rate of interest is based on the index and margin that will be used to make subsequent rate or payment adjustments over the term of the loan, the advertisement would be required to include (i) an equally prominent statement in close proximity to the advertised payment or rate to the effect that the payment or rate is subject to adjustment and the time period when the first adjustment will occur, and (ii) a prominent statement in close proximity to the advertised payments that the advertised payments do not include amounts reserved for property taxes and insurance, if applicable.

   - *Misrepresentations about Government Endorsement.* Making any statement in an advertisement that the loan product offered is a "government loan program," "government-supported loan," or is otherwise endorsed or sponsored by any federal, state, or other government entity, unless the advertisement is for an FHA loan, VA loan, or similar loan program that is in fact endorsed or sponsored by a federal, state or local government entity.

Misleading Use of Current Lender's Name. Using the name of the consumer's current lender in an advertisement that is not sent by or on behalf of the consumer's current lender, unless the advertisement (i) discloses with equal prominence the name of the person or creditor making the advertisement, and (ii) includes a clear and conspicuous statement that the person making the advertisement is not associated with, or acting on behalf of, the consumer's current lender.

Misleading Claims of Debt Elimination. Making any claim in an advertisement that the mortgage loan product offered will eliminate debt or result in a waiver or forgiveness of a consumer's existing loan terms with, or obligations to, another creditor.

Misleading Claims Suggesting a Fiduciary or Other Relationship. Using the terms "counselor" or "financial advisor" in an advertisement to refer to a for-profit mortgage broker or mortgage lender, its employees, or persons working for the broker or lender that are involved in offering, originating, or selling mortgages.

Misleading Foreign-Language Advertisements. Providing information about some "trigger terms" or required disclosures, such as an initial rate or payment, only in a foreign language in an advertisement while providing information about other trigger terms or required disclosures, such as information about the fully indexed rate or fully amortizing payment, only in English in the same advertisement.

- *Early TILA Disclosures.* To assure that transaction-specific disclosures are provided the consumer early enough to use while shopping for a mortgage loan, early TILA disclosures (e.g., the so-called "initial TIL"), which currently are required only for residential mortgage transactions to finance the purchase or initial construction of a principal residence, would now be required for all covered loans, including home loan refinancings. (Note: This rule would merely conform regulations to the usual industry practice of providing early TILA disclosures for all covered loans.) Early disclosures would have to be delivered to the consumer at the time of loan application or placed in the mail within three business days after application, consistent with the current rule, and no fee (other than a bona fide and reasonable fee to cover the cost of a credit report) would be permitted to be imposed on the consumer before delivery of the early TILA disclosures (although delivery would be presumed to occur three business days after mailing of the disclosures).

Overview of the HUD Proposed Rule

The HUD Proposed Rule would amend Regulation X, which interprets and implements RESPA, to (i) require "loan originators" (a new defined term that includes both mortgage lenders and mortgage brokers) to issue to consumers upon request a revised four-page form of Good Faith Estimate ("GFE") that is intended to disclose accurate costs of closing and key loan terms in a form that may be used by the consumer to comparison-shop for a loan among competing loan originators during a 10-business-day period in which certain of the estimated costs must be made available without change, within tolerances for accuracy; and (ii) to require settlement agents to complete a modified form of HUD-1 or HUD-1A Settlement Statement (collectively, "HUD-1") based on information provided by the loan originator that compares costs actually charged at closing with costs estimated on the GFE, including all loan originator compensation.

The proposed form of GFE would be expanded from a one-page to a four-page document (although the lengthy disclosure of Required Particular Providers currently required by Reg. X, §3500.7(e) would be eliminated) with content organized as follows:

Page 1. Under the heading *Good Faith Estimate (GFE)*, this page consists of a summary of (i) *Important Dates* (including specific dates until which the quoted interest rate, loan origination charges, and monthly payment and other settlement charges are available and, if the applicant elects to proceed with the loan application, the number of days after which the loan must be closed and the number of days preceding closing by which the interest rate must be locked); (ii) *Loan Terms* (including specific loan amount, term, interest rate, and initial monthly payment, rate lock period, and indications of whether the interest rate, loan balance, or monthly payments can increase after closing, and whether loan terms include a prepayment penalty, balloon payment, or monthly escrow for property taxes, insurance, and other obligations); and (iii) *Settlement Charges* (including only the totals of estimated Adjusted Origination Charges and All Other Settlement Charges detailed on page 2). This new summary format is intended to increase consumer awareness of loan terms and closing costs and to allow the consumer to easily compare various loan quotes by various loan originators.

Page 2. Under the heading *Understanding Your Estimated Settlement Charges*, this page consists of an itemization of estimated settlement charges grouped by major cost categories with a single total amount estimated for each such category and a final dollar figure of the Total Estimated Settlement Charges. Categories include (i) Adjusted Origination Charges (referred to as "Block A" charges); and (ii) Charges for All Other Settlement Services (referred to as "Block B" charges), the latter consisting of subcategories for required services selected by the loan originator, lender title insurance services, required services that the applicant can shop for, government recording and transfer charges, reserves for property taxes and insurance, interim or per diem interest charges, homeowner's insurance, and optional owner's title insurance.

Page 3. Under the heading *Important Information and Instructions*, this page sets out information about (i) how to shop for a loan offer, (ii) understanding how estimated charges may change at closing (including the categories of charges that cannot be increased at closing, the total of all other charges that can increase by 10% or less at closing, and charges that are not subject to a tolerance and can increase) and (iii) trade-offs between the interest rate and "up-front" settlement charges the applicant may choose, using examples for comparison of the terms of the loan quoted by the GFE and the results of the applicant's choosing either a lower rate with resulting higher settlement charges or a higher rate with resulting lower settlement charges.

Page 4. A continuation under the heading *Important Information and Instructions,* this page sets out information about (i) the applicant's financial responsibilities as a homeowner (including the obligation to pay for annual property taxes, homeowners, flood, and other property insurance, homeowners association and similar fees, and other property related charges, with a non-binding estimate of all such annual charges), (ii) how to apply for a loan, (iii) how to get more information (including by reading relevant government publications, such as HUD's Special Information Booklet), (iv) comparing GFEs obtained from different loan originators (including a chart, or worksheet, for use in comparing estimates side by side), and (v) the fact that the lender may receive additional fees by selling the applicant's loan in the secondary market at some future date after settlement that have no effect on loan terms or settlement charges paid by the applicant.

Disclosure of mortgage broker compensation on the modified form of HUD-1 would radically differ from current regulations, requiring most particularly that all loan origination charges of the lender and broker be disclosed together as a lump sum on the GFE and Line Item 801 of the HUD-1 (denominated as "Our Service Charge") and any compensation paid by the lender to the mortgage broker (denominated as "Your Charge or Credit for the Specific Interest Rate Chosen," in lieu of the more common industry term "yield spread premium") be credited to the borrower in reduction of that Service Charge on Line Item 802 to produce a net charge or credit to the borrower (denominated as "Your Adjusted Origination Charges") on Line Item 803. Cross references are made on each of these line items to the corresponding lines on the GFE where these amounts were estimated using these same terms to facilitate an easy comparison by the borrower of actual charges to those estimated.

Settlement agents also would be required to prepare and read aloud to the consumer at closing a new form of addendum to the HUD-1, referred to as the "Closing Script," comparing actual costs charged at closing with estimated costs on the GFE and to explain to the consumer in particular whether actual costs exceed those estimated within the allowed tolerances for accuracy, including mortgage broker compensation, and whether detailed loan terms and related information disclosed on the GFE vary from actual loan terms as set forth in the promissory note secured by the mortgage.

Loan originators failing to comply with the proposed GFE requirements, including charging the consumer amounts exceeding charges itemized on the GFE by more than the permitted tolerances, would be deemed to have violated RESPA, Section 5. Failure to comply with proposed regulations for completion of the HUD-1, including the so-called Closing Script, would constitute a violation of RESPA, Section 4. Although there currently are no sanctions that may be imposed for violations of RESPA, Sections 4 or 5, HUD has announced its intent to seek from Congress statutory authority to impose civil money penalties for violations of RESPA, Sections 4, 5, 6, 8, 9, and 10 and to seek injunctive and equitable relief in cooperation with state regulators. HUD also would seek statutory authority to require that a copy of the HUD-1, presumably complete with the "Closing Script" addendum, be delivered to consumers at least three-business-days in advance of loan closings.

The loan origination process under the HUD Proposed Rule would be divided into two distinct stages to facilitate the consumer's ability to shop for a mortgage: the GFE Application stage and the Mortgage Application stage:

- *GFE Application Stage.* The loan origination process would begin with the consumer's completing a new short-form of GFE Application with a loan originator (either a lender or mortgage broker) in which only such information reasonably necessary to make a preliminary credit decision is provided, specifically limited to the consumer's name, social security number, property address, gross monthly income, best estimate of property value, and the amount of the loan sought. The loan originator then must provide the consumer a GFE within three business days if credit is preliminarily approved (by timely delivering the GFE in hand or placing it in the mail or, if applicant agrees, by fax, e-mail or other electronic delivery) conditioned only on final loan approval following full underwriting and appraisal of the property securing the mortgage. Estimated charges for all settlement services (other than origination charges and per diem interest dependent upon the interest rate quoted) must be held available by the loan originator for a minimum period of ten business days (effectively a calendar two-week period) from the date of delivery of the GFE during which the consumer may obtain and compare other GFEs from competitors and make a determination as to the best available loan terms. The loan originator could not charge or collect a fee for its services during the GFE Application stage other than a fee limited to the cost of providing the GFE, including the cost of an initial credit report.

- *Mortgage Application Stage.* When the consumer compares GFEs from competing loan originators and selects a particular loan originator offering the most attractive loan terms and/or services, the consumer would next complete a Mortgage Application with that loan originator that provides expanded personal and financial information, including bank and investment account, employment, and asset and liability information needed for final underwriting. If the consumer submits a Mortgage Application to a loan originator during the 10-business-day "availability" period following the issuance of the GFE by that loan originator, the non-interest rate dependent settlement charges itemized on the GFE must remain in effect until closing, absent "unforeseeable circumstances" (a new defined term that includes both *acts of God* and certain unanticipated underwriting needs such as a second property appraisal or flood insurance) and within permitted tolerances, and the interest rate and interest-rate dependent settlement charges must remain in effect from and after the date that the consumer elects to "lock in" the rate, presumably in accordance with the loan originator's rate lock procedures. Generally, the loan originator would be required to approve any Mortgage Application taken during this 10-business-day period unless the loan originator determines that there is a change in the consumer's eligibility for the loan based on the final underwriting process, including the verification of information in and developed from the GFE Application. If the Mortgage Application is rejected based upon such a determination of a change in eligibility, the loan originator must then document the basis for such a determination and maintain those records for a period of three years. The loan originator in that case must notify the consumer of any such rejection within one business day after the credit decision (although this notification requirement appears to conflict with the controlling provisions of §202.9 of Regulation B to the Equal Credit Opportunity Act (ECOA) regarding notification of consumers of adverse credit decisions). At Mortgage Application, the loan originator may require the consumer to pay a loan application or other fee to initiate the loan application process.

In other significant provisions of the HUD Proposed Rule, HUD would:

- *Permit Average Cost Pricing and Negotiated Discounts.* To increase competition among settlement service providers and lower settlement costs, HUD proposes to permit pricing to consumers based on average costs and negotiated discounts, including volume-based discounts, so long as the borrower is not charged more than the discounted price. The permissibility of average cost pricing and volume-based discounts currently is suspect because, to the extent these practices benefit the lender or other settlement service provider making a referral of the service business, the discounts could be deemed a "thing of value" given as a disguised referral fee in violation of RESPA, Section 8. To clarify their permissibility, HUD would amend the definition of "thing of value" [Reg. X, §3500.14(d)] to expressly provide that a discount negotiated by settlement service providers is not a "thing of value," provided that no more than the discounted price is charged to the borrower and disclosed on the HUD-1. Average cost pricing could be based on either of two methods: (i) actual average price charged for the service on a national or regional basis over a recent averaging period of six-months preceding the GFE Application with respect to any loan; or (ii) tiered pricing contracts, provided the projected number of loans used in calculating the average is equal to the number of loans actually closed by the loan originator during that six-month averaging period. If a loan originator uses average cost pricing for any class of transactions during a particular period, the same pricing would have to be used for every transaction within that class for which a GFE Application was received during that period. The loan originator in that case would also be required to maintain documentation supporting the accuracy of its calculation of average costs for that particular period for at least three years.

- *Prohibit Upcharges*. Third party fees disclosed on the GFE would not be allowed to exceed the estimated amounts to be paid the third party settlement service providers and such fees reported on the HUD-1 could not exceed the amounts actually paid to such third parties. Thus, even earned mark-ups that may be justified based upon actual services performed by the lender or mortgage broker in connection with services performed by third parties would seem to be prohibited under this interpretative rule. It appears, therefore, that to collect any such earned compensation to which they may be entitled, the lender or mortgage broker would have to lump the charge into "Our Service Charge" disclosed in Block #1 of the GFE and line item 801 of the HUD-1. [Note: HUD persists in its interpretation that RESPA, Section 8, prohibits "overcharges" and "upcharges" (or "mark-ups") despite separate opinions of the United States Courts of Appeal for the 2nd, 3rd, 4th, 7th, 8th, and 11th Circuits to the contrary.]

- *Restrict the Offering of Seller Discounts Conditioned on the Use of Affiliates.* HUD proposes to revise the definition of "required use" [Reg. X, §3500.2] targeted at prohibiting homebuilders from offering discounts, rebates, and other financial incentives to home buyers conditioned on the use of the homebuilder's affiliated mortgage company and/or title insurance agency, although nominally the prohibition would apply to others in affiliated business arrangements. Homebuilders currently are permitted to offer financial incentives in the form of discounted packages of settlement services to homebuyers conditioned on the use by the homebuyer of an affiliated mortgage company or title company in connection with the purchase of the property so long as the package of settlement services is optional to the homebuyer and the discounts are true discounts below the prices that otherwise are generally available to the consumer and are not recouped elsewhere in the settlement process. Although requiring the use of an affiliate is prohibited under affiliated business arrangement regulations, the definition of “required use” currently has an expressed “carve out” that permits the offering of discounts or rebates to consumers for the purchase of multiple settlement services without violating the “no required use” prohibitions. HUD, however, has considered disincentives to be a violation, such as penalties in the form of additional fees or more onerous contract terms if the homebuyer declines to use the affiliate. Under the proposed rule, HUD would now equate positive incentives, expressly the discounted package of settlement services, with negative incentives, such as such imposing additional fees or punitive contract terms. HUD’s proposal is based on the barest anecdotal accounts of homebuilders’ abuse of the rule by their alleged recoupment of discounts through the charging of higher home prices or by higher fees and/or interest rates charged by their affiliates, which accounts seem contradicted by the only objective evidence discussed in the form of surveys conducted by respected J. D. Powers & Associates, which found satisfaction among consumers of the benefits offered by the homebuilders. The revised definition would state that the offering by a “settlement service provider” (a term that would generally exclude a homebuilder, as the seller and party to the transaction) of an optional package or combination of bona fide settlement services to a borrower at a total price lower than the sum of the prices of the individual settlement services would not constitute a “required use.” Thus, it would appear that such optional discounts could be offered directly to homebuyers by the affiliated mortgage companies and title companies, although HUD suggests in its analysis that such offers could not be made only to customers of their affiliated homebuilders.

- *Deregulate the FHA 1% Origination Fee Limitation.* HUD would revise FHA regulations to remove the specific limits on the amount an FHA mortgagee may collect directly from the borrower to compensate the mortgagee for expenses incurred in originating and closing an FHA-insured mortgage loan (subject to the authority of the FHA Commissioner to set limits on such direct fees in the future). FHA regulations limit only payments between FHA mortgagors and mortgagees, and do not regulate payments between mortgagees. HUD is aware that in recent years mortgage brokers have routinely been paid additional compensation by FHA mortgagees in the form of yield spread premiums to supplement the FHA origination fee (which is limited to 1% of the loan amount for permanent loans or 2.5 % for construction loans, excluding mortgage insurance premiums) paid directly by the borrower at closing. Now, with improvements in consumer disclosures under the proposed rule that will make total loan charges more transparent, HUD believes that market forces will effectively lower such charges for all borrowers, including FHA borrowers, and it is no longer necessary to regulate FHA origination fees.

Conclusion: Proposed Rules are Not a Fait Accompli

Adoption of Final Rules in the precise form and content proposed will face significant legal and political obstacles. Although the comment period for the FRB Proposed Rule has closed, the comment period for the HUD Proposed Rule has been extended 30 days to June 12, 2008. Thereafter, each of the expected hundreds of comments received from interested parties, including national trade associations, non-profit consumer advocacy groups, industry attorneys, and numerous mortgage lenders and brokers, title companies, property appraisers, and other settlement service providers with a stake in the rules must be reviewed and considered by staff as a matter of administrative rulemaking procedure before Final Rules may be adopted. The two proposed rules should also be harmonized during this review period to the extent they conflict, such as the manner in which the disclosure and payment of mortgage broker compensation would be regulated. Moreover, each agency also infringes on the regulatory turf of the other, with, for example, the FRB proposing to regulate both mandatory escrow accounts and loan servicers' conduct traditionally regulated by HUD under the authority of RESPA, and HUD concerning itself with the disclosure of loan terms and features of adjustable rate mortgage programs traditionally regulated by FRB under TILA.

Both agencies nevertheless expect, or perhaps hope, to have Final Rules adopted by year-end 2008 (i.e., during the current presidential administration). Once adopted, the Final Rules under applicable administrative law are subject to a 60-day review by Congress, during which time there would be a last opportunity for interested parties to lobby Congress for relief from particular provisions before the Final Rules are effective. Certainly the adoption of Final Rules in some form and content must be expected given the current political climate, but the lobby strength and sway of major special interest groups (such as the National Association of Home Builders, National Association of Realtors, Mortgage Bankers Association of American, National Association of Mortgage Brokers, American Land Title Association, and their hundreds of state counterparts) to influence the final form and content that the regulations may take should not be discounted.

The Final Rules once adopted may still be subject to legal challenge. The interpretive rulemaking authority of the agencies is arguably exceeded in some respects and may be subject to being set aside by a proper court. Of particular concern in that regard is the questionable authority of HUD to impose a mandatory form of Good Faith Estimate (GFE) that not only requires estimates of settlement charges as contemplated by Congress in enacting RESPA §5(c), but also requires that the GFE serve as a form of open offer of the interest rate and other loan terms and a guarantee of itemized settlement charges, within tolerances for accuracy, for a period of time during which the offer may be accepted by the consumer and thereby contractually obligate the loan originator. RESPA, §5(c), however, requires only that each lender provide loan applicants a "good faith estimate of the amount or range of charges for specific settlement services the borrower is likely to incur in connection with the settlement as prescribed by [HUD]" at the time the lender provides the applicant the Settlement Information Booklet prescribed by that section. While HUD has been delegated rulemaking authority by statute to interpret and implement RESPA to achieve its purposes, it does not have the authority to itself legislate or create regulations "out of whole cloth." Such a mandatory form of GFE that must be issued even before loan application and that imposes liability on all mortgage loan originators to provide specific loan terms and guaranteed settlement charges arguably is not a rational interpretation of the mere disclosure of estimated charges contemplated by Congress, and HUD may ultimately be forced to appeal to Congress to enact necessary statutory authority to support this linchpin of its proposed rule.

Moreover, other proposed provisions may be subject to challenge for HUD's failure to comply with requirements of the federal Administrative Procedures Act. That Act regulates the rulemaking process and requires that an agency demonstrate reasoned decision making. The most critical factual material that is used to support an agency's position must be made public in the proceeding and exposed to the possibility of refutation by interested persons during a comment period. This is of particular concern in the matter of HUD's proposed revision of the defined term "required use" that would prohibit seller discounts conditioned on the use of the seller's affiliated mortgage or title company as discussed in this memorandum. In the HUD Proposed Rule, for example, the agency makes unsubstantiated assertions that the discount offers of homebuilders are "disingenuous" because the cost to the builders of incentives and discounts have been built into the sales price of the homes and accordingly are not true discounts (but instead are penalties in the form of higher sales prices). To support such an assertion, HUD presents no factual data or analytical studies at all, but instead sets out only a few unsubstantiated, unattributed, and unreviewable one-sentence anecdotal accounts of consumer complaints to the effect that to get the benefit of the discounted settlement services offered by the homebuilder the consumer paid a higher sales price or a higher interest rate or origination fee than the "market rate." The failure to conduct any analysis of factual data and present the data and analysis as the underlying rationale for the proposed change in the rule that may be scrutinized and refuted by interested persons in accordance with the requirements of the Administrative Procedures Act may subject the HUD Proposed Rule to challenge on this issue.

This memorandum is intended to provide our clients only a general overview of the salient terms and features of these proposed rules, and the text of the proposed rules themselves should be referred to for a more detailed account and understanding. The FRB Proposed Rule was published in the Federal Register on January 9, 2008 (73 FR 1671) and may be conveniently accessed and downloaded at http://edocket.access.gpo.gov/2008/pdf/e7-25058.pdf, and the HUD Proposed Rule was published in the Federal Register on March 14, 2008 (73 FR 14030), complete with copies of proposed form revisions and instructions for completion of the forms, at http://edocket.access.gpo.gov/2008/pdf/e8-10634.pdf .