DATE: August 30, 1999

SUBJECT: UNDERSTANDING THE NEW FEDERAL PMI CANCELLATION LAWS

INTRODUCTION

Mortgage lenders routinely require borrowers to obtain private mortgage insurance when financing a home purchase if the borrower's down payment is less than 20% of the purchase price (or when refinancing a home loan if the borrower's appraised equity in the property is less than 20%). Private mortgage insurance, or "PMI," indemnifies the mortgage lender against a portion of any financial loss incurred by the lender if the borrower defaults in the payment of principal, interest or other amounts due under the loan terms. Premium costs typically are payable monthly and are added to the borrower's scheduled mortgage installment payment.

PMI premium costs can be significant: On a typical $100,000 mortgage loan with only a 5% down payment, for example, premiums can amount to $65 per month and increase monthly mortgage costs in the early loan years by more than 8%. In past years mortgage lenders often had continued the mortgage insurance requirement for the life of the loan even though the borrower's eventual equity build-up far exceeded the 20% equity requirement, and the courts had upheld the lenders' right to enforce life-of-loan coverage under general contract principles. But borrower-paid private mortgage insurance required in connection with a *residential mortgage* is now subject to new cancellation and automatic termination rights of homeowners under the federal Homeowners Protection Act of 1998 (the "HPA") that could significantly reduce the borrower's finance costs over the life of the loan. A residential mortgage for purposes of the HPA means a consensual first- or second-mortgage loan made since July 29, 1999, to finance the purchase, initial construction, or refinancing of a *single-family, primary residence*.

The HPA generally requires automatic termination of private mortgage insurance imposed by the lender as a condition of a residential mortgage when, according to the initial amortization schedule for the mortgage, the loan amount will be paid down to 78% (or 77% for certain so-called *high risk* loans) of the original value of the property securing the loan. And borrowers with good payment histories generally are entitled to cancel private mortgage insurance even earlier when the loan amount is scheduled to be paid down to 80% of the secured property's original value. This article briefly examines borrowers' substantive rights of cancellation and automatic termination of private mortgage insurance under the HPA and the corresponding duties of mortgage lenders and servicers to comply with this new federal legislation, including the duty to provide written consumer notices to borrowers of their rights .

CANCELLATION AND AUTOMATIC TERMINATION RIGHTS

Cancellation. A lender's requirement for borrower-paid private mortgage insurance in connection with a residential mortgage must be cancelled upon the written request of a borrower with a *good payment history* on the date that the principal balance of the loan, based solely on the *initial amortization schedule* for the loan in the case of fixed-rate loans or amortization schedules in the case of adjustable-rate loans, is scheduled to reach 80 percent of the original value of the residence securing the loan if the following conditions are satisfied:

(1) the borrower must have submitted a *request in writing* to the servicer of the loan that cancellation be initiated,

(2) the borrower must have a *good payment history* with respect to the loan, and

(3) the borrower must have satisfied any reasonable requirement of the lender or current holder of the loan for evidence that the value of the residence securing the loan has *not declined below the original value* of the property and for certification that the equity in the residence has not been encumbered by a *subordinate lien*.

The borrower also may cancel the requirement for private mortgage insurance in connection with the loan earlier than the date provided for in the initial amortization schedule based on *actual* payments. The cancellation date in that event is the date on which the principal balance of the loan reaches 80 percent of the original value of the residence based upon the borrower's actual payments, such as when the borrower prepays principal on the loan.

Automatic Termination. If not earlier canceled by the borrower when the principal loan balance is first scheduled to reach 80%, the requirement for private mortgage insurance in connection with a residential mortgage will *automatically terminate* on the date that the principal balance of the loan, based solely on the initial amortization schedule or amortization schedules for the loan, is first scheduled to reach 78 percent of the original value of the residence securing the loan, if on that date the borrower is current on the payments required by the loan terms. If the borrower is not then current on payments, the requirement for private mortgage insurance will terminate on the date thereafter on which the borrower becomes current on the payments required by loan terms.

Final Termination. If the requirement for private mortgage insurance in connection with a residential mortgage loan is not otherwise canceled or terminated under the cancellation and automatic termination provisions of the HPA, in no case may such a requirement be imposed beyond the first day of the month immediately following the date that is the *mid-point of the amortization period* of the loan (e.g., the 180th month of a 30-year term) if the borrower is current on the payments required by the loan terms.

Key Definitions. The *initial amortization schedule* from which the cancellation and termination dates are determined means a written amortization schedule that under the HPA must be prepared by the lender and delivered to the borrower at closing of the loan and that shows the amount of principal and interest due at regular intervals to retire the principal balance and accrued interest over the amortization period of the loan and the unpaid principal balance of the loan after each scheduled payment is made. *Original value* with respect to the residence securing the loan means the lesser of the sales price of the residence, as reflected in the contract of sale, or the appraised value of the residence at the time of the loan closing. *Good payment history* for purposes of the borrower's qualifying for PMI cancellation under the HPA effectively means that the borrower has not made a mortgage payment on the loan that was 30 days or longer past due during the 12 months preceding the cancellation date or a mortgage payment on the loan that was 60 days or longer past due during the 12-month period preceding that.

DISCLOSURES AND NOTICE REQUIREMENTS

Mortgage lenders must provide borrowers certain written notices of their PMI cancellation and automatic termination rights both at the time of loan closing and annually thereafter during the term of the loan. Lenders additionally must make written notification to borrowers when the lender's requirement for PMI has been cancelled or terminated. No fee may be charged or other cost imposed on the borrower in connection with the giving of any of these notices or other information required of the mortgage lender under the HPA.

Disclosures Required at Closing. Written notices required of mortgage lenders under the HPA differ slightly in form and content if the residential mortgage variously is either a fixed-rate, adjustable-rate, or a so-called *high risk* loan:

- ***Fixed Rate***. The mortgage lender must provide the borrower both a *written amortization schedule* and a *written notice* informing the borrower generally that a borrower with a good payment history may request PMI cancellation when the principal balance of the loan is first scheduled to reach 80% of the original value of the secured property based solely on the initial amortization schedule, or earlier based upon actual payments, and that the borrower may cancel the requirement for PMI on a certain date indicated in the notice if certain enumerated conditions are satisfied; that the PMI requirement otherwise will automatically terminate when the principal balance of the loan is first scheduled to reach 78% of that original value on a certain date indicated in the notice; and that there are exceptions to cancellation and automatic termination under the HPA for so-called *high risk* loans that may apply to the borrower's loan and whether these exceptions apply at that time to the borrower's loan.

- ***Adjustable Rate***. The notification requirements of the mortgage lender differ in the case of an adjustable rate mortgage in that the mortgage lender is neither required to provide the borrower a written amortization schedule nor to designate specific cancellation or automatic termination dates in the written notice. Instead, the mortgage lender must inform the borrower that the cancellation and automatic termination dates will be determined solely on amortization schedules for the residential mortgage and that the servicer will notify the borrower when the cancellation date is reached or when the PMI requirement is terminated.

- ***High Risk.*** Certain rights of cancellation and automatic termination of private mortgage insurance under the HPA do not apply to any residential mortgage that at the time of loan closing has *high risks* of default associated with the extension of the loan so as to require the imposition or continuation of the requirement for PMI beyond the cancellation or automatic termination dates called for under the HPA. Whether a residential mortgage is such an excepted transaction must be determined in accordance with guidelines published by Fannie Mae and Freddie Mac in the case of conforming loans or by the mortgage lender in the case of any other residential mortgage (in which latter case the high risk loan will nevertheless automatically terminate under the HPA when the principal loan balance is first scheduled to reach 77% of the original value of the secured property according to the amortization schedule or schedules for the loan). Fannie Mae and Freddie Mac so far have expressly declined to define *high risk*, however, in recent published policy statements. If a residential mortgage is determined to be such an excepted high risk loan under the HPA, the mortgage lender must provide the borrower written notice that the rights of cancellation and automatic termination of required PMI do not apply to the loan, but that in no case may a requirement for PMI in connection with the loan be required beyond the first day of the month immediately following the date that is the mid-point of the amortization period of the loan if the borrower is current on the payments required by the loan terms.

Disclosures Required After Closing. Annual disclosures must be provided to the borrower by the mortgage lender or servicer both for residential mortgages covered by the HPA and for existing mortgages made before its effective date. Written notification to the borrower is also required upon cancellation or automatic termination of private mortgage insurance under the HPA.

- ***Annual Disclosures***. The mortgage lender or servicer each year must provide borrowers a written statement of their cancellation and automatic rights under the HPA and an address and telephone number that borrowers may use to contact the servicer to determine whether PMI may be cancelled. This annual written statement may be incorporated into the standardized form of Annual Escrow Account Statement required under applicable RESPA provisions.

- ***Annual Disclosures for Existing Mortgages.*** The mortgage lender or servicer must also provide borrowers of residential mortgage loans entered into before the July 29, 1999, effective date of the HPA with annual written statements that PMI required in connection with their loans may, under certain circumstances, be cancelled by the borrower with the consent of the lender or in accordance with applicable state law along with an address and telephone number that the borrower may use to contact the servicer to determine whether PMI may be cancelled.

- ***Notification of Cancellation or Termination***. Within 30 days after the cancellation or termination of a PMI requirement under the HPA, the mortgage lender or servicer must make written notification to the borrower that the private mortgage insurance has terminated and that no further premiums or other fees in connection with PMI shall be due or payable by the borrower. No payments or premiums in connection with PMI may then be required or collected from the borrower more than 30 days after the cancellation or automatic termination date and the loan servicer is required to account for and return to the borrower any unearned premiums held by the mortgage insurer or the servicer within 45 days after the cancellation or automatic termination date. If the mortgage lender or servicer determines that any residential mortgage does not meet the requirements for cancellation or termination, however, the mortgage lender or servicer must make written notification to the borrower of that determination and the grounds relied upon to make the determination (including the results of any appraisal used in that determination).

[**NOTE**: Cancellation and automatic termination rights under the HPA do not apply in the case of *lender-paid* private mortgage insurance required in connection with a residential mortgage. However, the HPA requires a prospective mortgage lender when requiring lender-paid private mortgage insurance to provide the applicant a written notice no later than the date of issuance of a loan commitment that lender-paid mortgage insurance differs from borrower-paid PMI and may not be cancelled by the borrower; that the requirement for lender-paid mortgage insurance usually results in a higher interest rate charge to the borrower; that lender-paid mortgage insurance terminates only when the insured residential mortgage is refinanced, paid-off or otherwise terminated; that the two types of mortgage insurance each have benefits and disadvantages (as illustrated by a generic analysis of the differing costs and benefits for each type for a hypothetical residential mortgage over a 10-year term); and that lender-paid mortgage insurance may be *tax-deductible* for federal income tax purposes. An additional one-time written notice by the mortgage lender or servicer is required within 30 days after the date on which the PMI requirement would have automatically terminated under the HPA had it been borrower-paid PMI indicating that the borrower may wish to review financing options that could eliminate the requirement for private mortgage insurance in connection with the residential mortgage.]

PROTECTED STATE LAWS

The provisions of the HPA preempt and supercede any state law relating to requirements for obtaining or maintaining private mortgage insurance in connection with residential mortgages, cancellation or automatic termination of PMI, and any required disclosure of information addressed by the HPA *except* for previously passed state laws in connection with private mortgage insurance that are not *inconsistent* with the provisions of the HPA and that were in effect on or before January 2, 1998 (or were then in effect and amended before July 29, 2000).These *protected state laws* are not considered inconsistent with the HPA if the state law provides for greater consumer protections in the form of required termination of PMI at an earlier date or when a higher principal loan balance is reached than provided by the HPA or that requires consumer disclosures that provide more information or disclosures that must be provided more often or earlier than required by the HPA.

The states of California, Connecticut, Maryland, Minnesota, Missouri, New York, North Carolina, Oregon, Texas, and Virginia are reported by the Mortgage Bankers Association of America (MBA) to have passed state laws regulating PMI before January 2, 1998, and would have these protections. (The states of Illinois and

Washington passed state laws effective July 1, 1998, after this grandfathering date that consequently are pre-empted by the federal statute.) Brief summaries of the PMI notice, cancellation and termination provisions of these protected state laws are set out in an attachment to this memorandum. Recent related regulatory and legislative developments for the states of New York and Minnesota also are reported in the StateBeat section of the summer edition of the *Guardian Monitor*, a mortgage finance newsletter produced by our firm.

EFFECT ON TRUTH IN LENDING DISCLOSURES

PMI premiums are defined as finance charges for purposes of consumer disclosures required under the Truth in Lending Act (TILA)and are figured in the calculation and disclosure particularly of the Payment Schedule, Finance Charge, and Annual Percentage Rate (APR). TILA disclosures must be based on the legal obligation between the parties to the loan transaction, and the Payment Schedule and other material disclosures must reflect all components of the Finance Charge, including PMI for the time period in which there is a legal obligation to maintain the insurance.

Official Staff Commentary to Regulation Z (Truth in Lending), §226.18(g) published April 6, 1999 (64 F.R. 16614) requires that the Payment Schedule reflect the automatic termination of PMI at 78% of the original secured property value. Comment 18(g) – 5 in this regard requires that the Payment Schedule reflect the borrower's PMI payments "until the date on which the creditor must automatically terminate coverage under applicable law, even though the consumer may have a right to request that the insurance be cancelled earlier." This means that the Payment Schedule on TILA disclosure statements must reflect all monthly PMI payments — ending on the precise month in which PMI payments would be automatically terminated under the HPA. The fact that any borrower with a demonstrated good payment history may be entitled to earlier termination may be ignored for TILA disclosure purposes. Mortgage lenders may rely on earlier Commentary regarding assumptions to be used for variable-rate transactions and their discounted and premium rate features when calculating Payment Schedules for variable-rate transactions involving PMI.

Although this Commentary was effective March 31, 1999, *mandatory compliance* with its disclosure requirements was deferred until March 31, 2000, to accommodate mortgage lenders' needs to reprogram computer software used to calculate the values of the Payment Schedule, Finance Charge, APR and other TILA material disclosures. The software in any case must be programmed to first calculate the amount equal to 78% of the secured property's appraised value (or sales price, if lower) and to determine the month in which the principal loan amount is scheduled to be paid down to that amount by reference to an integrated loan amortization schedule. These variables must then be captured by the system to calculate a Payment Schedule in which PMI payments are reflected only until the month in which the lender must automatically terminate PMI coverage under the HPA and the Total of Payments used in the calculation of the Finance Charge and APR is correspondingly reduced.

FANNIE & FREDDIE GUIDELINES

Fannie Mae as a matter of policy set forth in its recent Announcement 99-06 has extended similar benefits as those of the HPA to *other* borrowers by implementing an automatic termination provision that applies to *all* Fannie Mae mortgages closed *before* July 29, 1999, as well as any mortgages closed on or after that effective date that are not covered by the HPA's cancellation and automatic termination provisions. Mortgage lenders naturally first must comply with federal law (and to any protected state laws if not preempted by federal law) with respect to residential mortgages covered by the HPA regarding the cancellation or automatic termination of borrower-paid PMI and related disclosure obligations if federal law differs from this announced policy. Particularly, mortgage lenders must *not* give initial federal disclosures required and appropriate under the HPA in the case of these mortgage loans for which Fannie Mae is extending similar benefits as federal law (but which are not covered by the HPA and could be interpreted as conferring on the borrower statutory rights to which the borrower is not entitled at law).

Generally, Fannie Mae is extending borrower-initiated cancellation rights and automatic termination rights to all its first mortgage loans closed after July 29, 1999, even when secured by one-family *second homes* or when secured by one-family principal residences where loan proceeds are used for other than the purchase, initial construction, or refinancing of the property. Its announced policy also requires automatic termination of PMI based on the mid-point of the mortgage amortization period for all first- and second-mortgage loans closed *before* July 29, 1999, and first-mortgage loans closed after that effective date that are secured by 1-4 family investment properties and 2-4 family principal residence properties. PMI required in connection with first- and second-mortgage loans closed on or after July 29, 1999, that are secured by a one-family, principal residences or second homes must automatically terminate at 78% of the original value of the secured property in accord with like provisions of the HPA. Borrower-initiated cancellation requests may be based on the *current value* of the secured property as well as the *original value* of the property required under the HPA provided the borrower has an acceptable payment record and meets applicable loan-to-value ratio criterion detailed in the policy announcement.

Freddie Mac in its recent Bulletin 99-4 similarly extended some of the benefits of the HPA to residential mortgages secured on second homes closed on or after July 29, 1999, and on one-family, primary residences or second homes closed prior to that effective date. Generally, Freddie Mac loans secured by one-family, primary residences or second homes that are originated on or after July 29, 1999, must comply with the HPA automatic termination requirements and, effective January 2, 2001, loans of this type originated before the July 29, 1999, effective date must be automatically terminated at the mid-point of their amortization periods. In a departure from the announced policies of Fannie Mae, however, these automatic termination rights expressly were not extended to Freddie Mac loans secured by 2-4 unit primary residences or 1-4 unit investment properties.

COMPLIANCE ENFORCEMENT

Generally, any mortgage lender, servicer, or mortgage insurer that violates a provision of the HPA may be held civilly liable to the borrower to whom the violation relates for both actual and statutory damages, court costs, and attorneys fees. Servicers enjoy some limitation on liability, however, and cannot be held liable for any failure to comply with provisions of the HPA if its failure is due to the failure of a mortgage insurer or mortgage lender to comply with its statutory duties. Specifically, a mortgage lender (other than certain depository institutions), servicer, or mortgage insurer may be found liable to an aggrieved borrower for *actual damages* sustained as a result of the violation, including interest on that amount at a rate determined by the court from the date of the violation, plus *statutory damages* as may be allowed by the court not exceeding $2,000 for each violation, costs of the court action, and reasonable attorney fees as determined by the court. In the case of a *class action* suit, liability is limited to such amount as the court may allow not exceeding $1,000 as to each member of the class or a total recovery in any class action, or series of class actions arising out of the same violation by the same liable party, not exceeding the lesser of $500,000 or 1 percent of the *gross revenues* of the liable party as determined by the court. Total recoveries in class action suits against certain depository institutions in this regard are limited to the lesser of $500,000 or 1 percent of the *net worth* of the liable institution. Any civil action by a borrower must be brought within two (2) years after the date of the discovery of a violation that is the subject of the suit.

Compliance with the requirements imposed by the HPA additionally are enforceable under section 8 of the Federal Deposit Insurance Act by the appropriate federal banking agency delegated enforcement authority with respect to depository institutions, including variously the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the Federal Credit Union Administration Board, and the Farm Credit Administration. These agencies are granted broad enforcement powers under the HPA. Specifically, the HPA provides that any violation of the HPA shall be treated as a violation of any other act from which these agencies derive their authority or enforcement powers and these agencies may exercise any other authority conferred on them by these acts or otherwise by law for purposes of enforcing compliance with any requirements imposed under the HPA. In carrying out its enforcement responsibilities under the HPA, each agency first must notify any mortgage lender or servicer of its failure to comply with one or more provisions of the HPA; when applicable, require the mortgage lender or servicer to correct the account of the borrower to reflect the proper date on which the mortgage insurance should have been cancelled or terminated under the act; and require the mortgage lender or servicer, when applicable, to reimburse the borrower in the amount of any unearned premiums paid by the borrower after the date on which the obligation to make premium payments terminated under the act. ❐

[**NOTE:** The Homeowners Protection Act of 1998 (112 Stat 900, P.L. 105-216 105th Congress, July 29, 1998) is codified at 12 U.S.C. § 4901, *et seq*.]