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MEMORANDUM

TO: Clients and Friends of the Firm

FROM: Al Alsup

DATE: January 28, 2003

SUBJECT: Mortgage Lenders under New Home Mortgage Disclosure Act (HMDA) Regulations will be Required to Report New Categories of Loan Data Aimed at Monitoring Subprime and Predatory Lending Practices Beginning January 1, 2004

BACKGROUND: HMDA REGULATIONS

The Federal Reserve Board (FRB) has postponed for one year the original January 1, 2003, effective date for new amendments to Regulation C[1] aimed at monitoring so-called subprime and predatory lending practices. Responding to mounding industry requests, the FRB granted a postponement of the mandatory compliance date to January 1, 2004, in order to give reporting institutions adequate time to take the steps necessary to ensure full compliance with the new regulations, including reprogramming their computer data systems and retraining their employees. Regulation C and the Regulation C Commentary interpret and implement the federal Home Mortgage Disclosure Act (HMDA)[2], a federal statute that requires most depository institutions and for-profit, non-depository mortgage lenders to collect, report, and publicly disclose data about their originations, purchases, and refinancings of home purchase and home improvement loans. HMDA is intended to provide public and government officials statistical evidence that lenders are serving the housing needs of the neighborhoods and communities in which their institutions are located and are not engaging in discriminatory lending patterns and practices.

Regulation C requires that lenders report data about:

- *Each application or loan*, including the application date; the action taken and the date of that action; the loan amount, the loan type and purpose; and, if the loan is sold, the type of purchaser;
- *Each applicant or borrower*, including ethnicity, race, sex, and income; and
- *Each property*, including location and occupancy status.

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[1] The new amendments to Regulation C and the Staff Commentary to Regulation C were published in the Federal Register this year in successive Final Rules on February 15, 2002 (67 F. R. 7222), May 8, 2002 (67 F. R. 30771), and on June 27, 2002 (67 F. R. 43217 and 67 F. R. 43218).
[2] The Home Mortgage Disclosure Act is codified at 12 U.S.C. 2801-2810

Lenders must report this data to their supervisory agencies[3] on an application-by-application basis using a loan application register format, generally referred to as the HMDA Loan/Application Register, or HMDA/LAR.[4] The HMDA/LAR must be filed each year by March 1 following the calendar year for which the loan data are compiled and must be made available to the general public (with certain fields redacted to preserve applicants' privacy). The Federal Financial Institutions Examination Council (FFIEC), acting on behalf of all supervisory agencies, then compiles the reported information and prepares an individual disclosure statement for each reporting institution, aggregate reports for all covered lenders in each metropolitan area, and other reports, all of which are made available to the general public. Lenders must maintain their HMDA/LAR records for a period of three years and their disclosure statements for five years.

The new amendments to Regulation C and the Regulation C Commentary among other changes will require covered institutions to report additional categories of loan data, including pricing of certain high-price loans (i.e., the spread between the APR and comparable U. S. Treasury Securities when that spread exceeds certain thresholds), the lien status of the loan, whether the loan is subject to the regulations of certain high-cost, high-price loans under the federal Home Ownership Equity Protection Act (HOEPA), and whether the secured property is a mobile home. Lenders will be required to collect this additional data commencing January 1, 2004, for reports due not later than March 1, 2005. However, some of the amended regulations will go into effect January 1, 2003, including requirements that lenders use 2000 census data for their 2003 HMDA/LAR reporting and that lenders conform their telephone application practices regarding the collection of race, national origin, and sex monitoring data to the current rules applicable to mail and Internet applications.

SOME REGULATIONS EFFECTIVE JANUARY 1, 2003

2000 Census Data. The Regulation C amendment[5] requiring reporting institutions to use 2000 census data, rather than 1990 census data used in past years, went into effect January 1, 2003, as previously scheduled. Lenders must use the census tract numbers and corresponding geographic areas from the 2000 Census for all applications and loans recorded on their 2003 HMDA/LAR and reported to their supervisory agencies by March 1, 2004. Because population and other characteristics for particular census tracts, such as the distribution of residents within a census tract by income, have significantly changed since 1990, required use of the 2000 census tracts and demographics is expected to produce more accurate and useful data in the HMDA disclosure statements and aggregate reports and enhance evaluations under the Community Reinvestment Act (CRA), which relies on census data.

Telephone Application Monitoring Data. The Regulation C amendment[6] requiring reporting institutions to conform their telephone application rules to rules already applicable to mail and Internet applications went into effect January 1, 2003. The amendment now requires lenders to ask applicants their race or national origin and their sex in applications taken by telephone. All loan applications, including applications taken by mail, Internet, or telephone must use a collection form for this purpose substantially similar to the form set out in Appendix B to Regulation C. For applications taken by telephone, the information in the collection form must be stated orally by the

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[3] Federal supervisory agencies, including the Office of Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of Thrift Supervision, the Federal Reserve System, and with respect to non-depository mortgage lenders, the Department of Housing and Urban Development, are identified in section 305(b) of HMDA (12 U.S.C. 2804(b)).

[4] Forms and instructions for completion of the HMDA Loan/Application Register are set out in Appendix A to Regulation C (12 CFR Part 203). Revised HMDA/LAR and related forms incorporating Final Rule provisions may be found at 67 FR 7242 et seq. and 67 FR 43225 et seq.

[5] Final Rule published in the Federal Register May 8, 2002 (67 F.R. 30771).

[6] Final Rule published in the Federal Register June 27, 2002 (67 F.R. 43217).

lender, except for information that pertains uniquely to applications taken in writing. Although lenders must ask the applicant for this information, the applicant cannot be required to provide it. Lenders are not required to provide the data if the applicant fails or refuses to answer. In that case, lenders are instructed to enter a code for "information not provided by applicant in mail or telephone application." These rules for collecting and reporting data on ethnicity and race of applicants were adopted to conform to the 1997 Guidance issued by the Office of Management and Budget ("OMB"). The amendment is expected to better serve the fair lending enforcement purposes of HMDA by improving upon the data collected on race, ethnicity, and sex.

NEW CATEGORIES OF DATA THAT LENDERS MUST COLLECT BEGINNING JANUARY 1, 2004

Beginning January 1, 2004, reporting lenders must collect new categories of data aimed at monitoring so-called subprime and predatory lending practices for all applications and loans recorded on their 2004 HMDA/LAR and reported to their supervisory agencies by March 1, 2005:

Rate Spread for High-Rate Loans. Lenders under new §203.4(12) of Regulation C must report the rate spread between the annual percentage rate (APR) and the comparable U. S. Treasury Security yield for home purchase loans, refinancings, and home improvement loans they originate if the spread is equal to, or greater than, three percentage points (3%) for first-lien loans or five percentage points (5%) for subordinate lien loans. To determine if the rate spread meets this threshold with respect to any loan, lenders must calculate the APR for the loan in accordance with Truth in Lending Act regulations[7] and compare the APR with the Treasury yield for securities of a comparable period of maturity as of the 15th day of the month prior to the date the final interest rate for the loan is set. Specifically, if the interest rate is set on or after the 15th day of any given month, the Treasury yield as of the 15th of that same month is to be used. If the interest rate is set before the 15th day of the month, the Treasury yield as of the 15th of the preceding month is to be used. The date the final interest rate is set is thought to more accurately reflect the lender's pricing decision than either the dates of application or loan consummation when rates may differ in a volatile rate environment. Often the applicable date will be the date that the rate is set or re-set under the terms of a written "lock-in" agreement, but if no lock-in agreement is executed, the applicable date is the date on which the lender sets the interest rate for the final time before loan closing. To determine the applicable Treasury yield, lenders must use the table "Treasury Securities of Comparable Maturity under Regulation C" to be maintained by the FFIEC on its Web site at http://www.ffiec.gov/hmda.[8] Lenders are not required to report the rate spread for loans that are purchased, loans for home improvement that are not secured by the dwelling, or loans that not subject to Regulation Z (Truth in Lending Act).

Loans Subject to HOEPA. Lenders under new §203.4(13) of Regulation C must report whether a loan is subject to the Home Ownership and Equity Protection Act of 1994 (HOEPA) as implemented by §226.32 of Regulation Z (Truth in Lending Act). HOEPA, or "Section 32," loans are any closed-end consumer credit transactions secured by the consumer's principal dwelling, other than a residential mortgage transaction (i.e., a mortgage loan to finance the acquisition or initial construction of a principal dwelling) or a reverse mortgage loan, if *either* (i) the annual percentage rate (APR) at consummation will exceed the yield on U.S. Treasury securities of comparable maturities by more than 8 percentage points for first-lien loans (10 percentage points for subordinate liens); or (ii) the total points and fees payable by the consumer at or before closing will exceed the

[7] Regulation Z, §226.18 (12 CFR Part 226)

[8] The FFIEC informally advises that the treasury tables will not be accessible on the FFIEC Web site until the extent of the information that must be provided has been determined and are not expected to be released until mid-year 2003. Reporting institutions should refer back to the FFIEC Web site periodically for regulation updates.

greater of 8% of the total loan amount or $400 (adjusted to $488 for 2003 based on CPI Index in effect June 1, 2002). 'Points and fees" for this purpose include not only charges labeled as point or fees and included in the prepaid finance charge by lenders but all compensation paid to mortgage brokers (except yield spread premiums paid P.O.C.), any third-party fees for which the lender receives any direct or indirect compensation, and fees paid to an affiliate of the lender. Although HOEPA status of loans originated by regulated depository institutions can be determined by bank examinations, this new rule is intended to collect data from non-depository lenders who account for approximately 57% of the dollar volume of all originations reported under HMDA and are not subject to such examinations.[9]

Lien Status. Lenders under new §203.4(14) of Regulation C must report the lien status of each originated loan or loan application that does not result in an origination (whether the application is approved but not accepted, denied, withdrawn, or closed for incompleteness), including specifically whether the loan is secured by a first lien on a dwelling, a subordinate lien on a dwelling, or a loan not secured by a lien on a dwelling. Lenders are not required to conduct title searches solely for HMDA reporting purposes. Rather, lenders are may report the lien status based upon the best information available to them at the time final action is taken on a loan application and may rely on information readily available to them that they reasonably believe to be accurate, such as the applicant's credit report or the applicant's own statement on the loan application. Because interest rates, and therefore APRs, may vary according to lien priority and the associated security risks, it is thought that records of lien status may help explain some pricing disparities that otherwise would not be apparent and enable data users to better analyze information on secured and unsecured home improvement loans.

Manufactured Homes. Lenders under §203.4(a)(5) currently are required to report the property type to which the loan or application relates, but under the new amendment lenders will be required to distinguish between one-to-four family dwellings other than manufactured housing (Code 1) and manufactured homes (Code 2). Manufactured housing loans are underwritten differently from other types of housing loans and tend to have higher denial rates. Distinguishing activity on these loans from that of other single-family loans will improve the ability of regulatory agencies and the general public to evaluate fair lending compliance. To identify manufactured home loans for this purpose, lenders must use the definition from the HUD regulations that establish construction and safety standards for manufactured homes. These federal regulations for factory-built housing generally require that such housing essentially be ready for occupancy upon leaving the factory and being transported to the construction site. The HUD definition is incorporated into Regulation C by reference to 24 CFR 3280.2 in §203.2(i) and the definition of "dwelling" in §203.2(d) expressly includes a ". . . mobile or manufactured home." If a lender does not know and cannot determine through reasonable means at the time of application whether the property is a manufactured home, however, the lender must report the property type simply as a one-to-four family dwelling (Code 1).

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[9] The Federal Reserve Board has released a Proposed Rule that provides guidance on the proper index to select for 30-year mortgages when determining whether a particular mortgage loan is subject to the so-called HOEPA or Section 32 "high-cost, high-rate loan" restrictions under Regulation Z to the Truth in Lending Act since the Treasury has now ceased auctioning 30-year securities. To determine HOEPA coverage under the Proposed Rule, the loan's APR must be compared with the yield on Treasury securities as of the 15th day of the month immediately preceding the month of application. Under the Proposed Rule, Treasury constant maturities as reported in Statistical Release H-15 must be used for determining the proper index to use for HOEPA testing. (The alternative of using actual auction results would be eliminated.) H-15 is posted on the FRB Web site at http://www.federalreserve.gov/releases/h15/update. Creditors must compare the APR on 30-year loans with the yield for a 20-year constant maturity (and not with the average long-term yield for maturities over 25 years or an estimate for a 30-year yield).

Definition of "Financial Institution" Revised to Expand HMDA Coverage. HMDA defines *financial institutions* for purposes of coverage to include those non-depository lenders "that are engaged for profit in the business of mortgage lending." Generally, non-depository lenders meet that definition if in the preceding year their home purchase originations (including refinancings of such originations) equaled at least 10% (by dollar volume) of all their loan originations. However, some non-depository lenders are not currently covered by HMDA under this volume percentage test even though they originate significant volumes of otherwise reportable loans because they are heavily engaged in other consumer lending, such as credit card lending, which skews the volume percentage test. To capture the data of this significant volume of loans lost by this exclusion, an additional dollar volume test will now be imposed under the HMDA amendments by which non-depository institutions will be deemed to be engaged in the business of mortgage lending and subject to HMDA if in the preceding year their home purchase originations (including refinancings of such originations) equal or exceed $25 million — even if those originations do not comprise at least 10% of their total originations. Based on a national average home purchase amount of $125,000, the $25 million threshold would mean that non-depository institutions that originate approximately 200 home purchase loans annually (and thereby process about 400 applications annually) would be subject to HMDA regulations.

Definition of *Application Revised to Include Pre-Approvals*. The definition of *application* in §203.2(b) has been revised to include a request for *pre-approval* as defined in the HMDA regulations for purposes of reporting denials of such requests. This new data on denials of pre-approval requests is intended to provide governmental agencies and the general public more complete information on the availability of home financing and to be useful in fair lending enforcement. The definition of *pre-approvals* for that purpose includes only those programs in which a creditor issues a creditworthy applicant a written commitment to extend credit that (i) specifies the maximum amount of credit that it commits to extend, (ii) the period of time during which the commitment is valid, and (iii) stipulates the conditions to the commitment, which must be limited to such conditions as identification of an acceptable property to secure the loan, verification before closing of no material changes having occurred in the applicant's creditworthiness, and other conditions not related to creditworthiness that are usual and customary in traditional loan commitments. For a pre-approval program to be covered by HMDA, the lender must issue a binding written commitment for approved applicants or deny the request and issue an adverse action notice under Regulation B (Equal Credit Opportunity Act) based on the lender's review of the applicant's credit record. The new rule will require that lenders report such pre-approval requests that are denied but will give lenders the option to also report pre-approval requests that are approved but not accepted. Lenders must continue to report pre-approval requests that are approved and result in a loan origination, but must distinguish these loans from other loan originations by the use of separate codes.

Definition of Home Improvement Loan Revised to Eliminate Lender Classification as a Condition. The definition of *home improvement loan* in §203.2(g) has been revised to include dwelling-secured loans made in whole or in part for purposes of repairing, rehabilitating, remodeling, or improving the dwelling (or the property on which the dwelling is located) regardless of whether the lender has classified it as a home improvement loan. Loans made for such home improvement purposes that are not secured by the dwelling continue to be reported only if the lender under its own classification system classifies the loan as a home improvement loan. Reporting of any portion of home equity lines of credit (HELOCs) used for home improvement purposes remains optional with the lender. The definition of *home equity line of credit* also is clarified to mean only open-end credit plans secured by a dwelling as defined in Regulation Z to the Truth in Lending Act (12 CFR Part 226).

Definition of Refinancing Revised to Require Both New and Existing Obligations to be Secured . Regulation C requires a lender to report refinancings of home purchase and home improvement loans. The definition of *refinancing* in §203.2(k) has been revised to eliminate inconsistencies in the way lenders currently report refinancings by choosing between four permitted scenarios, which in one case, for example, permits lenders to report consolidations of unsecured debt as a refinancing when the new loan is secured on a dwelling. Under the new rule, a *refinancing* would be defined as a loan transaction in which a new obligation satisfies and replaces an existing obligation by the same borrower when both the new and existing obligation are secured by a lien on a dwelling. In reporting the transaction as a refinancing, lenders may determine that the existing loan being refinanced is dwelling-secured by examination of relevant documentation or may rely on the borrower's representations in that regard. This definition is intended to provide a *bright line* test to determine whether any particular transaction is reportable as a refinancing. Modification, extension, and consolidation agreements (MECAs), for example, clearly would be eliminated from reporting because MECAs fail to satisfy the definitional element requiring that the existing obligation be satisfied and replaced by a new obligation and lien.