

Mortgage Banking Update

PATTON BOGGS LLP | OCTOBER 5, 2009

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UPDATE OF FHA LOAN ISSUE

As reported in the September 28 edition of the Mortgage Banking Update, the American Bankers Association, Consumer Mortgage Coalition and Mortgage Bankers Association sent a letter to the Federal Reserve and other regulators advising of an issue under the new Truth in Lending Act (TILA) rules that could significantly impact Federal Housing Administration (FHA) lending. The Fed's director of the Division of Consumer and Community Affairs issued a letter dated September 29 to the Department of Housing and Urban Development (HUD) addressing the issue raised by the trade groups.

The new TILA rules became effective on October 1, and the trade groups expressed concern about a prohibition applicable to a new category of closed-end mortgage loans created under the rules that are called higher-priced mortgage loans (HPMLs). Subject to a few exceptions, a mortgage loan is a HPML if it is secured by the consumer's primary dwelling and the annual percentage rate equals or exceeds a certain threshold. The threshold is 1.5 percentage points or 3.5 percentage points above the average prime offer rate for first-lien loans and subordinate-lien loans, respectively. The average prime offer rate is a rate computed by the Fed for fixed-rate loans with various terms to maturity and adjustable-rate loans with various initial-fixed interest periods.

As of October 5, the average prime offer rate for a 30-year fixed-rate loan was 5 percent. Based on this rate, a first lien 30-year, fixed-rate mortgage loan with an annual percentage rate of 6.5 percent or higher would be an HPML.

Among other restrictions, if a loan is an HPML the loan terms may not provide for a prepayment penalty that can be imposed more than two years after the loan is closed. The trade groups advised that the prepayment penalty restriction presents an issue with FHA loans.

FHA loans often are placed in pools that back securities guaranteed by Ginnie Mae. If a loan is prepaid in full during a month, Ginnie Mae requires that investors receive interest through the end of the month. As a result, many FHA loans provide that if a full prepayment is made on a date other than an installment due date, the borrower may be required to pay interest through the end of month. If the servicer does not collect the interest from the borrower, it would have to pay the interest out of its own funds.

LOOKING AHEAD:

MBA's St. Louis Education Seminar

October 7

Location: Clayton, Missouri

Topic: Truth in Lending and RESPA

Time: 1:00-5:00 p.m. CST

Patton Boggs participant:
Richard Andreano

How Will FHA Reforms Impact the Mortgage Industry?

October 14

Webinar Topic: Addressing Changes at FHA

Time: 1:00-2:00 p.m. EST

Patton Boggs participants:

Richard Andreano, Heather

Hutchings

Space is Limited

LBA's Bank Counsel Conference

November 13

Location: The Ritz Carlton, New Orleans

Topic: RESPA Reform: The Latest from Washington, DC

Time: 10:35-11:35 a.m. CST

Patton Boggs participant:

Richard Andreano

The commentary to the TILA rules provides that a requirement for the borrower to pay interest after the date of a full prepayment is deemed to be a prepayment penalty. The treatment of a requirement to pay interest after a full prepayment as a prepayment penalty, thus, presents an issue with FHA loans in view of the HPML restriction on prepayment penalties.

The Fed's director notes in the letter to HUD that FHA uses the monthly interest accrual amortization method and, as a result, if the consumer's prepayment occurs 10 days before the payment due date, the consumer owes the same amount of interest as if the prepayment occurs on the payment due date. The director then states "You [HUD] have advised the Board that, for federally-insured loans, due to the monthly interest accrual amortization method, HUD has not considered the payment of interest after the prepayment date as a prepayment penalty and has advised lenders that they need not disclose this practice as a prepayment penalty."

Recent HUD actions reflect that it does not view the requirement to pay interest after a full prepayment with an FHA loan as a prepayment penalty. The new forms of good faith estimate and HUD-1 under the Real Estate Settlement Procedures Act (RESPA) rule that becomes effective on January 1, 2010 provide for the disclosure of whether the loan has a prepayment penalty. In a version of the frequently asked questions (FAQs) being issued by HUD to provide guidance on the rule, HUD advised that the requirement with an FHA loan that the consumer pay interest through the end of the month, even if the loan prepays earlier in the month, is not a prepayment penalty. Subsequently, HUD removed the FAQ without explanation, and it is believed that HUD did so based on a discussion with the Fed.

Apparently the Fed staff had a change of heart. The director advises in the letter that the portion of the commentary regarding prepayment penalties "does not address the specific situation involving loans that generally use the monthly interest accrual amortization method." The director then states:

In light of the guidance given by HUD regarding the payment of interest after the prepayment date, and the fact that the Board staff commentary on this issue does not expressly address this issue in the context of monthly interest accrual amortization, the Board staff believes that lenders that use such an interest accrual method discussed above may continue to follow that practice. Lenders that engage in this practice would not be required to treat the interest charged from the date of prepayment until the next installment due date as a prepayment penalty for any purpose under Regulation Z.

This is interesting. When the commentary provision was adopted in 1986, in the preamble the Fed staff, in noting an example of a requirement to pay interest after a prepayment, expressly stated that "under regulations of the Department of Housing and Urban Development (24 CFR Parts 203, 213, 222, and 234), a lender who accepts prepayment in full on a date other

than the installment due date may assess a charge for interest to the end of the month.” But now the director is asserting that the commentary provision does not address the monthly interest accrual amortization method used with FHA loans.

The director concludes the letter by stating that “creditors may rely on this letter as an official interpretation of Regulation Z and, under TILA, liability will not apply to actions taken in good faith reliance on the guidance set forth in this letter, to the same extent as if this guidance were set forth in the commentary to Regulation Z.”

Lenders are advised to confer with their counsel, and also with their investors regarding whether the investors will consider this guidance sufficient to purchase FHA loans that are HMPLs.

A LOOK AT RESIDENTIAL FORECLOSURES, PART I

Although the recent MERS foreclosure and bankruptcy claim decisions have received publicity, we should remain cognizant of numerous lower court decisions at least initially refusing judicial foreclosure relief to lenders in states like New York. As courts see an increase in foreclosure volume, a number are rather sharply refusing summary judgment in judicial foreclosures, denying motions for the appointment of a receiver, and the like, because of what might be termed a lack of diligence by a mortgage loan servicer or its counsel. Many of these decisions are not officially reported, and are not on the public’s radar. But in some of the decisions the language directed at the lender/servicer shows that, not unexpectedly, some judges and plaintiff lenders have confusion on the power and authority of a securitization servicer to foreclose (both a standing and authority issue); some judges show a certain upset with incomplete or ineffectual lender affidavits, such as not explaining an unusual chain of title or gap thereof (a holder-in-due course issue), or what might be termed sloppy lawyering (separating an allonge from the note to be a separate exhibit). Fairly uniformly those courts demand that the foreclosing lenders and their attorneys fix the factual and legal deficiencies or face dismissal of the foreclosure cases with prejudice to renew, not receive an award of legal fees, and/or be sanctioned by the court.

These foreclosure and bankruptcy decisions are known to borrowers’ and regular lenders’ counsel, and also to borrower advocacy groups and advocacy Web sites. The advocacy groups are sharing information and some are apparently beginning to automate what works and what doesn’t work for borrowers going through judicial foreclosure or bankruptcy. Entrepreneurial advocates are hawking audit services at a modest price, under which a borrower’s loan and mortgage paperwork would be scrutinized by an expert for such things as possible TILA violations, missing documentation and arguments that the foreclosing lender is not a holder-in-due-course or lacks legal standing. Lenders are not standing still; many of our lender clients have performed or are undergoing their own audits.

For additional information on these issues, please contact [Jerry Phelps](mailto:jphelps@pattonboggs.com) at 214.758.3507 or he can be reached at jphelps@pattonboggs.com.

ARE YOU SAFE?

Is your company prepared for the significant changes that result from the implementation of the SAFE Act and the accompanying amendments to state laws and regulations?

Issues to Consider:

- Have you confirmed the effective dates of the various new requirements?
 - Example: In Maryland, mortgage loan originators (MLOs) seeking to apply for an initial license or renew an existing license must meet certain of the new prelicense requirements (i.e. 20 hours of education and a national and state exam) no later than December 31, 2010.
- Does your license exemption still apply?
 - Example: FHA-approved entities are no longer exempt from the Missouri residential mortgage loan broker license.
- Has an amendment changed the scope of your licensable activity?
 - Example: Effective January 1, 2010, companies that only hold the supervised lender license will no longer be permitted to make residential mortgage loans in South Carolina.
- Do you still need an in-state office?
 - Example: Effective January 4, 2010, New Jersey residential mortgage lender and broker licensees will not be required to maintain an in-state office, as long as the licensee is qualified to conduct business in New Jersey and maintains a registered agent for service of process.
- As a servicer, do your employees or independent contractors need a loan originator license in order to conduct loan modifications?
 - Example: In Michigan, individuals employed exclusively by mortgage servicers, who perform loan modification activities, must obtain a license by July 31, 2011, provided that HUD does not issue any contrary guideline or regulation.
- Can your loan originators pass the background check requirements?
 - All states that have enacted SAFE Act provisions prohibit the licensing of any MLOs who do not pass certain background check standards.

- Example: In Nebraska, effective July 31, 2010, an MLO license may not be granted to: (i) an individual who previously had a loan originator license or registration revoked, except that revocations that have been formally vacated or set aside will not be deemed a revocation for the purposes of this provision; (ii) an individual who has been found guilty of or pled nolo contendere to: (a) any felony; or (b) any misdemeanor involving fraud, dishonesty, breach of trust or money laundering; or (iii) an individual who has not demonstrated financial responsibility, character and general fitness to warrant a determination that the individual will operate honestly, fairly and effectively.
- Are you aware of the new fees for loan originator licensing?
 - All mortgage licensees, particularly those with a retail presence, should anticipate that their licensing costs will increase significantly as state regulatory agencies implement their SAFE Act licensing requirements.
 - Example: In Delaware, an MLO license application and licensing fees total \$530. An annual assessment of \$500 for each MLO licensee also is required.
 - Example: In Kentucky, the MLO license fee is \$80.

POLICY CHANGES ANNOUNCED FOR FHA MORTGAGEES

On Friday, September 18, HUD issued a series of mortgagee letters announcing changes to policy governing FHA-approved mortgagees. HUD issued a press release highlighting the changes announced in the mortgagee letters, indicating that it is pursuing additional changes through the rulemaking process. The Mortgage Banking Update will provide more details as HUD releases further updates and clarifications.

Effective January 1, 2010, FHA-approved lenders may not accept appraisals prepared by appraisers selected, retained or compensated by a mortgage broker or member of a lender's staff who is compensated on a commission basis tied to the successful completion of the loan. Lenders will be responsible for ensuring that the appraiser who performed the appraisal is correctly identified in the FHA Connection, and the lender will be subject to administrative sanctions if the appraiser identified in the FHA Connection is not the one who performed the appraisal. FHA also addresses appraiser fee issues generally and as they relate to the use of appraisal management companies. Appraisals will now be valid for a period of 120 days, which is two months shorter than the current requirement for existing properties and eight months shorter than the current requirement for properties that are proposed and under construction. Mortgagee Letter 2009-29 addresses treatment of appraisal portability in situations where a borrower switches

from one lender to another and an appraisal was ordered by and completed for the first lender. The new lender may order a second appraisal only in limited circumstances, as set forth in the mortgagee letter.

The Helping Families Save Their Homes Act of 2009 (HFSH) established a number of new eligibility requirements for FHA-approved lenders, such as rendering ineligible mortgagees who have an officer, partner, director, principal, manager, supervisor, loan processor, loan underwriter or loan originator who is engaged in business practices that do not conform to generally-accepted practices of prudent mortgagees or that demonstrate irresponsibility. Currently approved mortgagees will not be able to renew their status if they are not in compliance with six stated eligibility requirements. Additional changes related to HFSH and discussed in Mortgagee Letter 2009-31 include requiring lenders to submit requests to HUD to change their fiscal year-end date at least 90 days prior to the end of their current fiscal year-end date, requiring supervised mortgagees to submit annual audited financial statements (effective January 1, 2010), requiring mortgagees to use their HUD-registered business names in all advertisements and promotional materials related to FHA programs, establishing two new actions about which mortgagees must notify HUD and expanding FHA's civil money penalties authority. Provisions of HFSH were effective upon enactment, and FHA is working to update the appropriate HUD handbooks within the next 120 days.

Effective for transactions with case numbers assigned on or after November 17, 2009, HUD has revised a number of provisions related to streamline refinance transactions. In particular, the revisions relate to seasoning, payment history, net tangible benefit for the borrower, maximum combined loan-to-value ratio, maximum mortgage amount without an appraisal, the inclusion of discount points in existing debt for transactions with an appraisal, verification of assets needed to close, employment and income certification and elimination of the abbreviated uniform residential loan application.

FHA also announced its plans to propose an increase in the net worth requirement for approved mortgagees from \$250,000 to, initially, \$1 million. Such initial increase would be effective within one year of enactment of the rule, and the rule may provide that net worth requirements increase further in future years.

FHA also intends to propose changes to mortgagee approval and participation policies. Loan correspondents would no longer receive FHA approval for origination eligibility. Instead, supervised and nonsupervised mortgagees who underwrite and close loans originated by loan correspondents would assume responsibility and liability for all loans they originate and/or underwrite, including loans originated by loan correspondents. The rule changes will be subject to a public notice and comment period.