

EXECUTIVE SUMMARY

HOME OWNERSHIP AND EQUITY PROTECTION ACT IMPACT ON THE FINANCIAL INDUSTRY

On October 1st, 2002, new amendments to the Home Ownership and Equity Protection Act (Predatory Lending) will go into effect. The new amendments impose additional disclosure requirements and substantial limitations (for example, restricting short-term balloon notes) on home-equity loans bearing rates or fees above a certain percentage or amount. Additionally, the new amendments restrict certain acts and practices in connection with HOEPA loans.

Predatory lending encompasses a variety of practices. In general, predatory lending refers to abusive lending practices involving fraud, deception, structuring, or unfairness to the borrower. Some abusive practices are clearly unlawful, but others involve loan terms that are legitimate in many instances and abusive in others. Predatory lending has generally included the making of unaffordable loans based on the borrower's home equity without regard to the borrower's ability to repay; or refinancing a loan repeatedly and charging high points and fees each time the loan is refinanced, or engaging in fraud or deceptive practices to conceal the true nature of the loan obligation from the borrower such as packing loans with credit insurance without a borrower's consent.

HOEPA applies to closed-end home equity loans and refinancing of 1st mortgages. HOEPA does not apply to commercial loans, reverse mortgages transaction, open-end home equity loans, bridge loans with a maturity of less than one year for the purposes of acquiring or constructing a consumer's principal residence, a residential mortgage transaction to acquire or build a consumer's principal residence. If the closed-end loan is not secured by the borrower's principal residence, then it is not subject to HOEPA rules.

BALLOON PAYMENTS: HOEPA prohibits balloon payments on high cost HOEPA loans within the first 5 years of the loan. Lenders can structure loans that require a large balloon payment after the fifth year.

APR TRIGGERS: Under the HOEPA rules, the allowable spread for closed-end home equity loans first lien is now 8.00% (Previously 10%). The allowable spread for secondary loans will remain at 10.00%. Using a Treasury yield rate of 5.00%, a first lien mortgage APR that equals or exceeds approximately 13.00%, and secondary lien mortgage that equals or exceeds approximately 15.00% would be subject to HOEPA rules. It is important to note, that when determining HOEPA APR triggers, a comparable Treasury interest rate must be utilized in the calculation. Example, if the loan term is years, then the comparable Treasury interest rate that used is five years as well.

REFINANCING: The new rules prohibit financial institutions from refinancing closed-end home equity loans made during the 12-month period following the loan origination, unless the refinancing is in the borrower's best interest. The staff commentary to the amendment states that in determining whether a loan is in the borrower's best interest, consideration should be given to the totality of the circumstances at the time in which the credit is extended and whether the loan fees and charges are commensurate with the amount of new funds advanced, and the real estate related charges are bona fide and reasonable. Additionally, whenever a 1st mortgage is refinanced the loan is subject to HOEPA requirements.

LOAN DOCUMENTATION & DISCLOSURES: Many standard loan documents contain a boilerplate due on demand or call clause. Under the new HOEPA rules, these types of clauses are prohibited for any reason other than the borrower's default, or in connection with fraud or misrepresentation by the borrower. This provision was added to prevent lenders from accelerating a loan in order to cause a borrower to refinance. Additionally, new disclosures and statements will be required if credit insurance premiums are a part of the "Total Amount Borrowed".

NEGATIVE AMORTIZATION: HOEPA prohibits negative amortization on high cost loans covered

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by the Act. Negative amortization is where monthly mortgage payments are not sufficient to cover the principal and interest payments due on a loan, thereby temporarily decreasing equity in a home.

REPAYMENT ABILITY: Under the new HOEPA rules, a lender may not engage in a pattern or practice of making HOEPA loans based on the equity in the borrower's home without regard to the consumer's repayment ability, taking into account the consumer's current and expected income, current obligations, and employment status. While most lenders will not provide a loan without an assessment of the ability to repay, some lenders will write a loan for customers based solely on the amount of equity they have in their home. This asset based financing can be a trap for the borrower when the borrower finds that their income will not support the refinancing, a lender may have undue leverage to force the refinancing and the subsequent opportunity to tack on additional fees that reduce equity. The new amendments create a presumption of a HOEPA violation when a HOEPA loan is originated without analysis and documentation of the borrower's ability to repay.

INSURANCE: Under the new HOEPA rules, optional single premium (Credit Life, A/H, Debt Protection and so on...) insurance for closed-end home equity loans will now be considered a fee, if paid at or before closing, thus triggering existing HOEPA rules for the fee-based triggers, which applies when a mortgage loan's total points and fees exceed \$480 (Index Annually) for 2002 or 8% percent of the Total Loan Amount, whichever is greater. Before October 1st, 2002 single premium credit insurance was nearly always added to the loan amount and financed as part of the loan. Thus, a loan with proceeds to the borrower of \$ 25,000 with a credit insurance premium of \$1,500 becomes a loan of \$26,500. Accordingly, the monthly loan payment was based on the loan amount of \$26,500 and borrower would pay interest on the insurance premium at the same rate as the original loan amount of \$25,000. Lender would then generally advance the entire insurance premium of \$1,500 to the insurance company at, or near, time of closing.

There has been a lot of industry confusion on whether or not the new HOEPA rules prohibits the use of single premium insurance and thereby requiring lenders to use only monthly based insurance products after October 1st, 2002. The new HOEPA rules did not eliminate or prohibit the use of single premium credit insurance (GROSS or

NET) by lenders, it merely changed the treatment of how the insurance premiums are to be considered and/or disclosed.

Both lenders and insurance companies who do not want to support HOEPA based loans and the additional requirements thereof are electing to implement monthly-based insurance premium products, thereby developing a product that circumvents HOEPA insurance triggers.

As a general rule MOB (Monthly Outstanding Balance) and level monthly products are the two primary monthly-based insurance products for the financial industry for credit life and accident & health (A/H) insurance. Under the MOB method, a simple-interest loan payment is developed such that the loan will amortize to 0 at the end of the loan term. Each month, the lender calculates the credit insurance premium due for the month, then the interest due for the month, and after reducing the payment by the total of the insurance premium and interest charges, applies the remainder to reduce the principal balance. MOB rates are expressed in cents per \$1,000 of protection, the amount of insurance protection and monthly insurance premium declines each month over the life of the loan.

In essence, the borrower pays the insurance premium monthly, based upon the amount of outstanding balance for that month and are always based on the net debt. Additionally, if a MOB loan has prepaid finance charges or other items that must be included as part of the finance charge, the disclosed payment amount also includes an insurance premium component. The procedure for calculating an APR for a loan with MOB insurance and additional fees requires that the payment the borrower makes to service the debt be determined for each month in the loan. The MOB credit insurance premium is excluded from the total payment the borrower makes because it is not part of either the amount financed or finance charge. The fundamental APR calculation involves finding a monthly rate (for monthly loans) that will amortize the amount financed to zero using the debt payment stream the borrower is required to make. The most common error when calculating a loan with MOB insurance results in a higher APR, because the MOB insurance premium is considered to be part of the finance charge (which they are not). Level monthly insurance products have the same insurance premium over the life of the loan.