



NC BANKERS
NORTH CAROLINA BANKERS ASSOCIATION

P. O. BOX 19999, RALEIGH, NC 27619-9916 / 800-662-7044 / FAX: 919/881-9909

Legal Memorandum

September 30, 2009

Vol. 41, No. 7

TO: *Legal Memorandum* Mailing List

RE: Rate Spread and High-Cost Home Loans – House Bill 1222

Before it adjourned in August, the General Assembly enacted legislation intended to update North Carolina's rate spread and high-cost home loan statutes. The legislation, House Bill 1222, was introduced at the request of the North Carolina Bankers Association and other interested parties. Signed into law by Governor Perdue earlier this month, the bill conforms North Carolina's laws governing subprime loans, or "rate spread home loans," with recent amendments to the Federal Reserve Board's Regulation Z (Truth-in-Lending) and Regulation C (Home Mortgage Disclosure) which address "higher-priced mortgage loans." Substantive differences in the standards applicable to subprime loans under North Carolina law and those now in Regulation Z and C required a lender to apply one set of standards for federal purposes and another for state purposes with respect to subprime loans. The amendments to Chapter 24 (Interest) of the North Carolina General Statutes contained in House Bill 1222 address issues resulting from those dual standards. Enclosed is a letter from Jim Creekman, Group Vice President of First Citizens Bank, which explains in detail the principal provisions of House Bill 1222 and their impact on banks' subprime lending activities. Jim was instrumental in the drafting and support of the bill in the General Assembly and his efforts are very much appreciated.

Please contact us if you have any questions regarding the issues discussed in this *Legal Memorandum*.

Sincerely,

Edmund D. Aycock
SVP and Regulatory Counsel



**First Citizens
Bank**

James E. Creekman
Group Vice President
In-House Counsel

September 25, 2009

Mr. Paul H. Stock, Esq.
Executive Vice President and Counsel
North Carolina Bankers Association
3601 Hayworth Drive
Raleigh, NC 27609-7218

Re: Updating North Carolina's Rate Spread Home Loan Statute

Dear Mr. Stock:

On September 7, 2009, Governor Beverly Perdue signed House Bill 1222 into law as Session Law 2009-457. The title to the Act is "An Act to Update the Rate Spread and High-Cost Home Loans Statutes, and to Make a Conforming Change to the Emergency Program to Reduce Home Foreclosures Act." The legislation was introduced through the joint efforts of consumer advocates and the North Carolina Bankers Association.

BACKGROUND

Over the past ten years, North Carolina has been a pioneer in crafting legislation to curb predatory and abusive home lending practices. In 1999, the General Assembly targeted "high-cost home loans" with the enactment of G.S. 24-1.1E. Imposing burdensome restrictions on these predatory loans, the legislature (i) made it extremely difficult for a lender to make high-cost home loans, (ii) effectively stripped high-cost home loans of their economic benefit, and (iii) imposed severe penalties on lenders that violated the provisions of the statute. As a consequence, most responsible lenders consider G.S. 24-1.1E to be the functional equivalent of a prohibition and do not make high-cost home loans.

By 2007, it became apparent that North Carolina's anti-predatory lending statute, though effective, did not afford adequate protection for subprime borrowers. As a consequence, government officials, consumer advocates, and representatives from the financial sector crafted G.S. 24-1.1F to address abuses in the subprime market. Our subprime lending statute was intended to regulate (but not prohibit) subprime loans, which are called "rate spread home loans" in G.S. 24-1.1F. What characterizes a rate spread home loans is an interest rate that is clearly above the current market rate but that is not so high as to trigger the anti-predatory lending provisions of G.S. 24-1.1E. Recognizing that there is a bona fide need for subprime lending in the marketplace, the General Assembly imposed two significant restrictions on rate spread home loans. First, prepayment penalties are prohibited, thus enabling a borrower to escape the onerous terms of a subprime loan by refinancing. Second, G.S. 24-1.1F imposes an affordability standard on mortgage lenders. A lender is prohibited from making a rate spread home loan unless the lender reasonably and in good faith believes at the time the loan is consummated that the borrower has the ability to repay the loan according to its terms and to pay applicable real estate taxes and hazard insurance premiums. The lender must document the borrower's ability to repay.

In the summer of 2008, the Board of Governors of the Federal Reserve System (the "Fed") weighed in for the first time on subprime lending by adopting amendments to Regulation Z ("Reg Z"), the federal regulation that implements the federal Truth-in-Lending Act, and Regulation C ("Reg C"), the regulation that implements the federal Home Mortgage Disclosure Act ("HMDA"). Instead of calling subprime loans "rate spread home loans" as we do in North Carolina, the newly added section of Reg Z that addresses subprime lending, Reg Z § 226.35 (12 CFR 226.35), refers to subprime loans as "higher-priced mortgage loans." The changes to Reg Z (which become effective October 1, 2009) were published in the Federal Register on July 30, 2008, at 73 FR 44522. The changes to Reg C (which also become effective October 1, 2009) were published in the Federal Register on October 24, 2008, at 73 FR 63329.

Unfortunately, the standards a lender must apply under the new federal regulation to determine whether a loan is a higher-priced mortgage loan and, if it is, to underwrite the loan, differ markedly from the corresponding standards contained in G.S. 24-1.1F as originally enacted. Requiring a lender to apply one standard for federal purposes and a different standard for state purposes imposes an unreasonable burden on lenders without any corresponding benefit to consumers. Recognizing this, consumer advocates and the North Carolina Bankers Association worked diligently to conform G.S. 24-1.1F to the new federal subprime lending regulations without sacrificing the additional protections afforded to consumers by North Carolina's subprime lending law. The result was the enactment of House Bill 1222.

SECTION-BY-SECTION ANALYSIS

Set forth below is a section-by-section explanation of the provisions of House Bill 1222 (Session Law 2009-457). A copy of the legislation may be found on the General Assembly's website.

SECTION 1

Section 1 contains technical amendments to G.S. 24-1.1E, our anti-predatory lending statute. For purposes of both closed-end loans and open-end credit plans, sums identified in G.S. 24-1.1E(a)(5)a.1 and a.2 are included in the calculation of "points and fees" only if paid by the borrower at or before closing. Conversely, compensation paid from any source to a mortgage broker (including compensation paid to a mortgage broker in a table-funded transaction) is included in the calculation of "points and fees" under G.S. 24-1.1E(a)(5)a.3, without regard to whether the compensation is paid (i) by the borrower, or (ii) at or before closing. This change effectively shuts the door on "yield spread premiums" by including in the calculation of "points and fees" all sums paid by the lender to the broker.

SECTION 2

Section 2 makes substantial changes to G.S. 24-1.1F, North Carolina's rate spread home loan statute:

1. The term "average prime offer rate" is added as a defined term. The average prime offer rate is the standard that will be applied beginning October 1, 2009, to determine whether a loan is a higher-priced mortgage loan under both Reg Z and Reg C. The definition of "average prime offer rate" contained in G.S. 24-1.1F(a)(2) mirrors the definition contained in Reg Z § 226.35(a)(2).
2. Because they are no longer needed, the definitions of "closed-end loan," "home loan," "obligor," and "open-end credit plan" have been deleted from G.S. 24-1.1F.

3. The definition of “rate spread home loan” has been rewritten – it is summarized on the attachment to this letter. The definition has undergone three substantive changes.
 - Bridge loans are now excluded from the universe of loans regulated by G.S. 24-1.1F. North Carolina’s “carve out list” – that is, the categories of loans listed in G.S. 24-1.1F(a)(7)a that are excluded from the definition of “rate spread home loan” – is now almost (but not quite) identical to the categories of loans listed in Reg Z §226.35(a)(3) that are excluded from the definition of “higher-priced mortgage loan.”
 - The requirement in former G.S. 24-1.1F(a)(3)f that the loan be for a certain purpose (such as purchase, construction, refinance, or debt consolidation) has been eliminated.
 - Most importantly, the federal standard that *must* be applied by a lender to determine whether a loan is a higher-priced mortgage loan under Reg Z (the average prime offer rate test) has been added as a third standard that *may* be applied by a lender to determine whether a loan is a rate spread home loan subject to the provisions of G.S. 24-1.1F.

A loan will not be considered a rate spread home loan subject to G.S.24-1.1F unless the loan’s annual percentage rate (“APR”) exceeds each of three different standards by a specified margin. A lender may choose to evaluate its loans under any one or more of the three standards. Because lenders will be required in any event to apply the federal standard to determine whether a loan is a higher-priced home loan for Reg Z purposes and for Reg C HMDA reporting purposes, many banks may elect for efficiency purposes to apply only the federal standard to determine whether a loan is a rate spread home loan subject to G.S. 24-1.1F, ignoring the other two North Carolina standards (which may, under certain circumstances, be more lender-friendly). Alternatively, a bank may elect to test the loan’s APR against the other two North Carolina standards only if the loan’s APR exceeds the average prime offer rate test.

4. The underwriting and affordability standards imposed by G.S. 24-1.1F(c) have been conformed to the underwriting and affordability standards contained in Reg Z and the Official Commentary for Reg Z. Under both G.S. 24-1.1F(c) and Reg Z §§ 226.35(b)(1) and 226.34(a)(4), a lender is prohibited from making a subprime loan to a borrower based on the value of a borrower’s collateral without due regard to the borrower’s repayment ability, including the borrower’s current and reasonably expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations. In making this determination, the same methodology and standards that apply under Reg Z to the underwriting of a higher-priced mortgage loan apply with equal force to a lender who makes a rate spread home loan in North Carolina. The methodology and standards that must be used are set forth in Reg Z § 226.34(a)(4) and the related Official Staff Commentary. **Because North Carolina’s underwriting and affordability standards for subprime loans have been conformed to the corresponding federal standards, North Carolina lenders will not be required to underwrite the same loan twice using different underwriting criteria.**

NOTE: One final comment. Although North Carolina lenders can now (i) use the same standard to determine whether a loan is a subprime loan for both federal and state purposes, and (ii) apply the same underwriting and affordability criteria for both federal and state purposes, there are still two significant differences between Reg Z § 226.35 and G.S. 24-1.1F:

Mr. Paul H. Stock, Esq.
September 25, 2009
Page 4

- **G.S. 24-1.1F(b) prohibits a lender from charging or collecting prepayment fees or penalties on a rate spread home loan. Reg Z § 226.35(b)(2) permits prepayment penalties, although it restricts the time within which a prepayment penalty may be assessed, the circumstances under which it may be imposed, and the amount of the penalty.**
- **Subject to certain exceptions, Reg Z § 226.35(b)(3) requires a lender to establish an escrow account for taxes and insurance, but may allow a borrower to cancel escrow twelve months after loan consummation. G.S. 24-1.1F does not contain a corresponding escrow requirement.**

SECTION 3

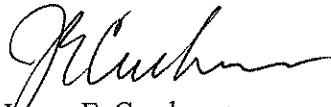
Section 3 amends G.S. 45-101, the "Definitions" section of the "Emergency Program to Reduce Home Foreclosures" adopted by the General Assembly in 2008 as part of House Bill 2623, Session Law 2008-226. The Emergency Program to Reduce Home Foreclosures applies only to subprime loans originated on or after January 1, 2005, but before December 31, 2007. The changes to G.S. 45-101 ensure that the Emergency Program will apply only to loans originated during that timeframe that satisfied the definition of a rate spread home loan under the standards that were in effect before October 1, 2009.

SECTION 4

Section 4 provides that the Act is effective October 1, 2009.

Please contact me if you have any questions concerning the matters addressed in this letter.

Yours very truly,



James E. Creekman
Group Vice President

Enclosure

**DETERMINING WHETHER A LOAN
IS A RATE SPREAD HOME LOAN
(OR SUBPRIME LOAN) SUBJECT TO G.S. 24-1.1F**

A loan is a rate spread home loan subject to the restrictions of G.S. 24-1.1F if *all* of the following apply:

1. The borrower is a natural person.
2. The debt is incurred by the borrower primarily for personal, family or household purposes (*i.e.*, the loan is a consumer-purpose loan).
3. The principal amount of the loan does *not* exceed to conforming loan size limit for a single family dwelling as established from time to time by Fannie Mae.
4. The loan is secured by the following collateral, and the collateral is located in North Carolina:
 - A manufactured home which is or will be occupied by the borrower as the borrower's principal dwelling.
 - Real property upon which is located an existing 1-4 family residential structure that is or will be occupied by the borrower as the borrower's principal dwelling.
 - Real property upon which a 1-4 family residential structure will be constructed using the loan proceeds, but only if the dwelling will be occupied by the borrower as the borrower's principal dwelling when construction is completed.
5. The loan is **NOT**:
 - An equity line of credit (as defined in G.S. 24-9).
 - A construction loan (as defined in G.S. 24-10).
 - A reverse mortgage transaction.
 - A bridge loan with a term of 12 months or less, such as a loan to purchase a new dwelling where the borrower plans to sell a current dwelling within 12 months.
6. The loan's annual percentage rate ("APR") exceeds *each* of the following:
 - The average prime offer rate test. As of the date the interest rate for the loan is set, the loan's APR exceeds the average prime offer rate for a comparable transaction by:
 - 1.5% or more, if the loan is secured by a first lien, or
 - 3.5% or more, if the loan is secured by a subordinate lien.

The "average prime offer rate" is an annual percentage rate published by the Federal Reserve Board that is derived from average interest rates, points, and other loan pricing terms currently offered to consumers by representative sample of creditors for mortgage transactions that have low-risk pricing characteristics. The Federal Financial Institution's

Examination Council (the FFIEC) maintains a rate spread calculator on its website: <http://www.ffiec.gov/ratespread/newcalc.aspx>. You can use this rate calculator to determine whether a loan is a rate spread home loan under § 24-1.1F(a)(7)f.1 and a higher-priced mortgage loan under Reg Z § 226.35(a)(1).

- The conventional mortgage rate test. The loan's APR exceeds the conventional mortgage rate by:

1.75% or more, if the loan is secured by a first lien, or

3.75% or more, if the loan is secured by a subordinate lien.

For purposes of this calculation, the "conventional mortgage rate" means the most recent daily contract interest rate on commitments for fixed-rate first mortgages published by the Board of Governors of the Federal Reserve System in its Statistical Release H.15, or any publication that may supersede it, during the week preceding the week in which the interest rate for the loan is set.

- Comparable yield on U.S. Treasury securities test. The APR for the loan exceeds the yield on U.S. Treasury securities having comparable periods of maturity by:

3% or more, if the loan is secured by a first lien, or

5% or more, if the loan is secured by a subordinate lien.

In making this calculation, you should use the same procedures and calculation methods that were applicable to loans that were subject to the reporting requirements of HMDA in effect prior to October 1, 2009. The yield on Treasury securities should be determined as of the 15th day of the month prior to the date the loan application was submitted.