

OUTSIDE COUNSEL

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New Restrictions on Predatory Lending in High-Cost Home Loans

On Oct. 3, Governor George E. Pataki signed an aggressive new consumer protection bill aimed at cracking down on "predatory lending."¹ The new legislation adds Section 6-1 to New York's Banking Law, Section 771-1 to the General Business Law, and Section 1302 to the Real Property Actions and Proceedings Law in an effort to bar lending practices identified as predatory. In so doing, New York joins North Carolina and Georgia as the only states to enact such laws.

New York's law applies only to "high-cost home loans." While the complete statutory definition of a "high-cost home loan" contains hundreds of words, the nutshell definition is a first lien mortgage loan that bears interest at least eight percentage points over U.S. treasury securities having comparable periods of maturity, or one in which points and fees exceed 5 percent of the total loan amount.²

The new law makes high-cost home loans subject to specific limitations and prohibitions against predatory practices. The list of predatory lending practices described in the statute is a true testament to the level of dishonesty and overreaching that exists.



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two percentage points;

- A loan may not compel arbitration that is oppressive or substantially in derogation of the rights of consumers;

- A loan may not be used to finance any credit life, credit disability, credit unemployment, credit property insurance, or any other life or health insurance premiums, or any payments for any debt cancellation or suspension agreement, except within certain narrow guidelines.

Furthermore, no lender or mortgage broker making or arranging a high-cost home loan may, *inter alia*:

- Engage in the unfair act or practice of "loan flipping," which is making a home loan to a borrower that refinances an existing home loan when the new loan does not have a tangible net benefit to the borrower;

- Refinance an existing home loan that is originated, subsidized or guaranteed by or through a state, tribal or local government, or nonprofit organization, which either bears a below-market interest rate at the time of origination, or has non-standard payment terms beneficial to the borrower which the borrower will lose as a result of the refinancing, unless HUD certified loan counseling is provided to the borrower and properly documented;

Law's Restrictions

These include the following restrictions:³

- A lender may not accelerate the indebtedness in its sole discretion, except in the case of good faith acceleration due to a borrower's failure to abide by the material terms of the loan;

- The loan may not have a scheduled balloon payment that is more than twice as large as the average of earlier scheduled payments, unless such payment becomes due and payable at least 15 years after the loan's origination;

- The loan may not have negative amortization under a payment schedule that causes the principal to increase rather than decrease;

- A lender may not increase an interest rate after default;

- A lender may not require more than two periodic installments to be paid in advance;

- A lender may not charge a borrower any fees to modify, renew, extend, or amend a high-cost home loan if thereafter the loan is still a high-cost home loan, or if the annual percentage rate has not been reduced by at least

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- Make a high-cost home loan without due regard to the borrower's repayment ability;

- Directly or indirectly, finance any points and fees in excess of 3 percent of the loan;

- Pay a contractor under a home improvement contract from the proceeds of a high-cost home loan other than by an instrument payable to the borrower or jointly to the borrower and the contractor;⁵

- Recommend or encourage default

on an existing loan or other debt;

- Accept or give any fee or payment other than for goods or services actually rendered;

- Charge a borrower points and fees in connection with the high-cost home loan if the proceeds of the loan are used to refinance an existing high-cost home loan held by the lender or its affiliate.

Bringing Action

Where predatory practices are found, the attorney general, the superintendent of banks, or any party to a high-cost home loan, may bring an action to void the loan agreement, thereby causing the lender to forfeit all rights to the principal, interest and other loan charges.

Even more damning than the usury law,⁶ the lender will not only forfeit all future payments of principal and

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interest, but will also be required to disgorge payments previously made by the borrower.⁷

While under certain circumstances good faith failures by lenders will be forgiven if the lender takes the required steps to cure the violation,⁸ anyone found to have intentionally violated the law will also be liable for actual damages (including consequential and incidental damages) and in certain cases, statutory damages including a penalty equal to the greater of \$5,000 or twice the points charged for the loan.⁹

Assignees and bona fide purchasers of a high-cost home loan do not have safe harbor protection. The law expressly provides that in any action by an assignee to enforce a high-cost home loan against a borrower in default more than 60 days or in foreclosure,¹⁰ the borrower may assert any claims in recoupment and all defenses to payment with respect to the loan, without time limitations, that the borrower could assert against the original lender.¹¹

Finally, Section 6-1 of the Banking Laws adds to the borrower's arsenal of remedies, injunctive, declaratory or other equitable relief, and an award of reasonable attorneys fees if a court so orders.¹²

The newly enacted lending reforms are aimed specifically at the sub-prime lending industry which extends credit to borrowers with higher probable default risk than traditional bank customers.

The industry contends that the higher interest rates and loan fees are needed to compensate the sub-prime lender for the increased risk of delinquency and the higher costs of loan servicing and collection associated with the loan.

On that basis, the concept of sub-prime lending is not inherently predatory. In fact, many sub-prime lenders provide the only viable option for individuals who are unable to secure loans in the prime market. Thus, legitimate sub-prime lenders are not the focus of the new law.

Rather, the law targets overreaching sub-prime lenders who view the sub-prime borrower market (mainly asset rich-cash poor populations such as the elderly, and low-income "bad-credit" groups) as a fertile playground for abuse.¹³

Perhaps one of the best illustrations to date of the pervasiveness of predatory lending occurred on Oct. 11, when Household International Inc., one of the largest lenders in the United States agreed to pay a record fine of \$484 million to settle nationwide allegations of predatory lending practices.

Approximately \$37 million of the fine will go to pay some 25,000 New York borrowers victimized by Household's predatory lending practices.¹⁴ Household's alleged abuses included concealing the true closing costs of loans from borrowers, adding thousands of dollars of unnecessary hidden insurance costs, charging individual borrowers thousands of dollars in points and excessive interest rates, and even refinancing of home loans at higher interest rates than borrowers were previously paying.

The New York State Banking Department reported that about 93 percent of New York borrowers were charged a maximum of 7.25 points on their loans from Household. Household agreed to the settlement after investigations by the New State attorney general, the state Banking Department, and attorneys general and regulators from 20 other states.

Household is not alone. Just weeks before the Household settlement, Citigroup agreed to pay \$215 million to settle predatory lending charges made by the Federal Trade Commission.

The legislature passed the predatory lending bill and Governor Pataki signed it over strong objection from the financial services industry.

Lenders argued this reform will unintentionally tie the hands of the majority of legitimate sub-prime lenders in the wake of its attack on the unscrupulous and predatory few, thereby foreclosing any opportunity sub-prime borrowers may have for obtaining financing. Money that otherwise would have been made available to the sub-prime borrowing market will flee to more lender-friendly venues leaving sub-prime borrowers, those the law was intended to protect, unfinanceable.

Another View

The contrary view has also been expressed.

The investment firm of Morgan Stanley surveyed 280 branch managers in the sub-prime lending industry nationwide and found no evidence to support the position that regulatory pressure, the threat of legal action, or changes to lending practices have dampened growth — even in North Carolina and Georgia, which have tough lending regulations.

Many believe that the law will have a positive effect and will actually boost the volume of business because borrowers and lenders alike will feel more comfortable with the lending process.¹⁵

It is interesting to note that the law was adopted by the Legislature on

July 2. The governor delayed its execution for three months to press for amendments to ensure that the state's legislation would pre-empt any attempted local regulation.

Albany watchers were surprised, therefore, that the governor signed the law on Oct. 3, when, just one week earlier, on Sept. 25, the New York City Council attacked the issue of predatory lending from a different angle.¹⁶

Rather than attempt to regulate lending practices, the City Council's bill prohibits the city from engaging in business with banks and other financial institutions that engage in predatory lending practices.

If this bill is signed into law by Mayor Michael Bloomberg, banks and other financial institutions will face unprecedented accountability in having to certify that they do not originate or purchase predatory loans and are not predatory lenders.

Conclusion

The predatory lending law is biting and tough. The penalties are severe and they leave little room for avoidance.

The stir of the new predatory lending law and the Household and Citigroup settlements should serve as huge incentives to lenders to move quickly to evaluate their lending practices and implement the required changes to ensure compliance with the new law, which will become fully effective 180 days following its enactment.

(1) 2002 N.Y. Laws 11856.

(2) *Id.* at §1, §6-1(1)(d). *Id.* at §6-1(1)(g).

(3) *Id.* at §6-1(2)(a-h).

(4) 2002 N.Y. Laws 11856, §1, §6-1(2)(l-q).

(5) 2002 N.Y. Laws 11856, §2. Conforming amendments have been made to the General Business Law provisions regulating home improvement contracts. New GBL section 771-(a) states no home improvement contractor shall engage in any activity, transaction or business or pay or receive anything of value in connection with the financing of a home improvement contract without first disclosing such activity and payment made therefor in a writing signed by all parties to the transaction.

(6) N.Y. Gen. Oblig. §5-511(1) (McKinney 2002). Where a loan made by a savings bank, savings and loan association or a federal savings and loan association is found to be usurious it will be voided and the lender will forfeit the entire interest on the loan, but not the principal paid by the borrower.

(7) 2002 N.Y. Laws 11856, §1, §6-1(2)(10).

(8) *Id.* at §6-1(2)(4).

(9) *Id.* at §6-1(2)(7).

(10) 2002 N.Y. Laws 11856, §3. Section 1302 has been added to the RPAPL to add additional pleading requirements for foreclosure actions. The plaintiff must allege compliance with the statutory high-cost home loan requirements in a foreclosure complaint.

(11) *Id.* at §1, §6-1(2)(13).

(12) *Id.* at §6-1(2)(9). *Id.* at §6-1(2)(8).

(13) 2002 Proposed Int. No. 67-A.

(14) Tania Padgett, "Household to Pay \$484M Fine," *Newsday*, Oct. 12, 2002.

(15) Ronald E. Roel, "Curbing Predatory Home Loan Scams," *Newsday*, Oct. 4, 2002 at C3. Joel Stashenko, "Pataki Signs Bill to Do Away With 'Predatory' Lending," *Newsday.com*, Oct. 3, 2002.

(16) 2002 Proposed Int. No. 67-A.