

COMPLIANCE & OPERATIONS ADVISOR

A HANDS-ON GUIDE TO RECENT DEVELOPMENTS



"FEE & EASY" HOME EQUITY LENDING: ARE YOU UNNECESSARILY FOREGOING FEE INCOME?

December 2, 1996

INTRODUCTION. Too many lenders have designed their revolving home equity credit programs in a fashion that unnecessarily forgoes increase in fee income opportunities. Because of the unique truth-in-lending regulatory requirement that a home equity credit agreement cannot change any term in the agreement after origination, lenders often fail to consider how they can legally escalate fees over the life of the home equity program. For example, in a home equity line of credit program with a ten year draw period and a ten year repayment period, today's \$18.00 NSF fee will look like a remarkable bargain nine years from now. Through careful program design, we can assist your institution in maximizing home equity-based fee income after loan origination.

Most prospective home equity borrowers focus on front-end fees, fees associated with opening a home equity line of credit account. Therefore, the institution with the lowest front-end fees, and particularly those institutions that offer home equity lines of credit with no application or origination fees, have been dominating the market for home equity lending. In contrast, home equity loan customers do not generally focus on the back-end, the termination of a home equity line of credit. Thus, fees such as termination fees generally do not figure prominently in consumers' thinking concerning home equity loans.

Consumers are willing to accept ongoing fees in exchange for the ease of using a home equity line of credit. A home equity line of credit opened on a no-fee basis can impose fees for returned items, fees for exceeding a credit line, fees for non-sufficient funds, fees for failure to use the line of credit over a certain period of months, as well as fees for such things as early termination of a multi-year line of credit. It is with respect to these fees that most home equity lenders are failing to maximize fee income after loan origination.

DISCLOSURE. Under Regulation Z, if a fee is imposed in order to open, use or maintain a revolving home equity credit line, the precise amount of the fee must be disclosed in the home equity line of credit program disclosure provided to

a prospective borrower at application. On the other hand, fees which are not imposed to open, use or maintain a home equity plan, such as fees for researching an account, paying late, stopping payment, having a check returned, or exceeding the credit limit, do not have to be disclosed in the home equity program disclosure.

LENDING DOCUMENTATION. Product design has been hampered by the truth-in-lending prohibition on changing the terms of a home equity line of credit plan, including increasing any fees or imposing any new fees, after the account has been opened. Fees can be increased after consummation, provided that the credit agreement is appropriately drafted. A home equity creditor is permitted to implement changes set forth in the home equity line of credit obligation that are contemplated on the occurrence of an event, as long as the triggering event and the resulting change are stated with specificity. Additionally, the fact that fees which are not imposed to open, use or maintain a plan do not have to be disclosed in the home equity program disclosure provided at application provides home equity lenders with a wonderful opportunity to engineer increases in fee income over time without having to provide government-mandated disclosure of a lender's escalating fee income.

FOREGOING DEFAULT INTEREST. Similarly, it is our experience that many lenders routinely charging a higher rate of interest on a first mortgage loan in the event of default do not apply a similar standard to the typical second (or lesser priority) mortgage loan represented by a home equity line of credit. A home equity line of credit can impose a default rate of interest under Regulation Z. Obviously, if a loan is in default, the rate of interest applied is not as important as the probability of repayment or recovery of the value of the loan, but there is nevertheless no reason apparent to us that a higher default rate of interest should not be imposed, in addition to a late charge.

CIVIL LIABILITY FOR DEFECTIVE LOAN DOCUMENTATION. Grady & Associates has recently had occasion to prepare or revise home equity lending

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products for a number of our clients. We would welcome the opportunity to engineer fee income increases through careful design of your institution's home equity lending program. While engineering increased home equity based-fee income may seem like a small detail, we are aware that one of the Midwest's largest residential mortgage lenders inappropriately addresses these items in its home equity lending program. The consequences of increasing fees in a manner that does not comply with the Truth-in-Lending Act and Regulation Z are serious. A home equity lender that increases a fee after origination, without customer consent, is exposed to civil liability. On a class action basis (presumably the mistake is made on a global basis through defective loan documentation), a home equity lender increasing fees without customer consent could be required to pay damages to the tune of the lesser of \$500,000 or 1% of the creditor's net worth.

Recent Projects:

- $\frac{3}{4}$ prepare training procedures to instruct customer contact staff on avoiding illegal prescreening of loan inquiries
- $\frac{3}{4}$ counsel wholesale residential mortgage lenders on the standards for assignee liability involving defective truth-in-lending disclosures (assignee liability under the Truth-in-Lending Act for an assignor's defective truth-in-lending disclosures is far broader than most secondary market players realize)
- $\frac{3}{4}$ prepare a loan participation agreement for a consortium-sponsored CRA lending program
- $\frac{3}{4}$ advise a holding company and financial institution subsidiary on establishing a title insurance agency, real estate brokerage agency, and a property and casualty insurance agency
- $\frac{3}{4}$ prepare commercial mortgage, assignment of rents and security agreement for acquisition and development lending

PUBLICATIONS

The New CRA: A Practical Guide to Compliance has recently been published by Irwin Professional Publishing. Authored by Francis X. Grady, *The New CRA: A Practical Guide to Compliance* explains the revised CRA regulations and provides a practical understanding of unresolved interpretive issues under the revised CRA regulations. *The New CRA: A Practical Guide to Compliance* is available for \$19.95 plus handling expense by calling Irwin Professional Publishing 1-800-634-3966, Ext. 2085.

CONFERENCE EVENTS

AMERICA'S COMMUNITY BANKERS 1997 NATIONAL MORTGAGE MARKETS CONFERENCE & SUPER MARKETPLACE, Tucson, Arizona, January 28, 1997 -- Mr. Grady will be speaking concerning risk-based pricing and subprime mortgage lending.

Seminar hand-outs from the conference are available.

THE CONTENTS OF THIS PUBLICATION SHOULD NOT BE CONSTRUED AS LEGAL ADVICE. READERS SHOULD NOT ACT UPON INFORMATION PRESENTED IN THIS PUBLICATION WITHOUT PROFESSIONAL COUNSELING.

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