

Winter 2004

## Modeling a Response to Predatory Lending: The New Jersey Home Ownership Security Act of 2002

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35 Rutgers L.J. 645 (2003-2004)

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# MODELING A RESPONSE TO PREDATORY LENDING: THE NEW JERSEY HOME OWNERSHIP SECURITY ACT OF 2002

*Baher Azmy\* and David Reiss\*\**

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The authors would like to thank the following people for helpful comments on earlier drafts: Linda Fisher, Deborah Goldstein, Beryl Jones, Rufina Lee, Daniel Medwed, and Kenneth Zimmerman. The authors also acknowledge the support of Seton Hall Law School and the Brooklyn Law School Summer Research Stipend Program. Thanks also to William Cusack and Diana Emerich for excellent research assistance.

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## I. INTRODUCTION

Home ownership in America forms an elemental part of the metaphorical American dream, conferring social status, financial security and stronger community ties to its beneficiaries.<sup>1</sup> These benefits have been extended to a growing portion of Americans in recent years, including minority and lower-income persons who have traditionally been excluded from access to the credit opportunities necessary to either purchase homes or collateralize their home equity into valuable liquid assets.<sup>2</sup> Indeed, over the past decade, an entirely new dynamic has emerged in the residential market: a wave of new mortgage products – including loans to “subprime” borrowers – and a host of newly prominent providers – including mortgage brokers, mortgage bankers and finance companies – have simultaneously developed to service this growing market sector.<sup>3</sup>

Some of those new providers, however, have engaged in unscrupulous business practices. Known as “predatory lenders,” they prey on vulnerable and financially unsophisticated persons, trapping thousands into exploitative loans that are as profitable for lenders as they are destructive for borrowers.<sup>4</sup> For years, predatory lending has sucked many billions of dollars out of the home equity and from the income of many vulnerable Americans<sup>5</sup> and has resulted in a rash of devastating residential home foreclosures throughout the nation.<sup>6</sup> In part because current federal mortgage regulations and state law fraud protections have not proved a sufficient deterrent, predatory lending

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1. See KENNETH JACKSON, *CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES* (1985).

2. According to a recent study by the U.S. Department of Housing and Urban Development (HUD), 40% of new homeowners since 1994 are minorities, even though they account for just 20% of the U.S. population. Similarly, African-American and Hispanic homeownership rates have been growing at twice that of white homeowners. OFFICE OF POLICY DEV. AND RESEARCH, DEP'T OF HOUS. AND URBAN DEV., *ISSUE BRIEF: FHA'S IMPACT ON INCREASING HOMEOWNERSHIP OPPORTUNITIES FOR LOW-INCOME AND MINORITY FAMILIES DURING THE 1990S*, at 3-4 (2000), available at <http://www.huduser.org/Publications/PDF/fha.pdf> (Dec. 2000); see also JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *THE STATE OF THE NATION'S HOUSING 15* (2003), available at <http://www.jchs.harvard.edu/publications/markets/son2003.pdf> (last visited May 7, 2004).

3. See *infra* text accompanying notes 22-36.

4. See *infra* text accompanying notes 16-19.

5. ERIC STEIN, COALITION FOR RESPONSIBLE LENDING, *QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING 2* (2001) (estimating that several categories of abusive lending practices cost American homeowners \$9.1 billion annually), available at <http://www.predatorylending.org/pdfs/Quant10-01.pdf> (July 25, 2001).

6. See *infra* text accompanying notes 87-94.

has been found in high concentrations in New Jersey.<sup>7</sup> Indeed, even defining a core concept of “predatory lending” has eluded regulators<sup>8</sup> and scholars<sup>9</sup> because, as with the doctrine of unconscionability, its manifestations are generally context-specific.<sup>10</sup>

New Jersey, by passing the Home Ownership Security Act in 2002 (HOSA or the Act),<sup>11</sup> became one of a handful of states to respond comprehensively to the problem of predatory lending within its borders.<sup>12</sup> The New Jersey legislature did not choose to specifically define “predatory lending” nor to simply craft a definition of the prohibited practice sufficiently broad so that common law courts could adjudicate its parameters on a case-by-case basis. Rather, following the lead of other states and a

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7. See *infra* text accompanying notes 24, 41-44.

8. See SENATE COMM. ON BANKING, HOUS. AND URBAN AFFAIRS, PREDATORY LENDING PRACTICES: STAFF ANALYSIS OF REGULATORS' RESPONSES (2000) (recommending that no additional regulations of “predatory lending” should be undertaken because no adequate definition exists to describe the practice); see also HUD-TREASURY TASK FORCE ON PREDATORY LENDING, CURBING PREDATORY HOME MORTGAGE LENDING 27 (2000) [hereinafter JOINT HUD-TREASURY REPORT] (declining to establish a specific definition of “predatory lending” but identifying core predatory lending practices that should be subject to regulation), available at <http://www.huduser.org/Publications/pdf/treasrpt.pdf> (last visited May 7, 2004).

9. See Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 511-13 (2002) (surveying variety of definitions proposed by scholars and regulators). Professors Cathy C. Engel and Patricia A. McCoy also demur from offering a precise definition of predatory lending, choosing instead to classify certain lending practices as unfair through a framework of law and economics. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1258 (2002). They suggest that predatory behavior includes loans that: (i) are structured to result in seriously disproportionate net harm to borrowers; (ii) engage in rent seeking; (iii) involve fraud or deceptive practices; (iv) lack transparency; and (v) require borrowers to waive meaningful legal redress. *Id.* at 1260.

10. Relying in part on a definition adopted by the New Jersey appellate division, the authors would define “predatory lending” as a set of practices, engaged in by investors, lenders, mortgage brokers and home improvement contractors, usually through aggressive or deceptive sales tactics, that are so disadvantageous or abusive that the borrower is subjected to an unreasonable risk of default and foreclosure. *Assocs. Home Equity Serv., Inc. v. Troup*, 778 A.2d 529, 536-37 (N.J. Super. Ct. App. Div. 2001).

11. N.J. STAT. ANN. § 46:10B-22 (West 2003).

12. See 2003 ARK. Acts 2598 (2003); CAL. FIN. CODE § 4970-4979.7 (West 2003); Fair Lending Act, GA. CODE ANN. § 7-6A-1-13 (2003); High Risk Home Loan Act, 2003 Ill. Laws 93-561; High Cost Mortgage Loan Provisions, MASS REGS. CODE tit. 209, § 32.32 (2003); 2003 N.M. Laws 436; 2001 N.Y. Laws 11856; Restrictions and Limitations on High Cost Home Loans, N.C. GEN. STAT. § 24-1.1e (2003); High Cost and Consumer Home Loans Act, 2003 S.C. Acts 42.

framework set up by the Federal Home Ownership Equity Protection Act (HOEPA),<sup>13</sup> New Jersey has designated certain practices abusive where they have little or no market justification when made in connection with already expensive residential mortgage loans and where they cause an unreasonable risk of foreclosure.<sup>14</sup> The Act fills an important regulatory gap left open by current federal and state law. By attempting to proscribe certain unjustifiable practices in connection with high cost, higher-risk loans, the Act goes a long way toward accomplishing its goals of simultaneously protecting home ownership and keeping an ample supply of credit available at reasonable terms to all borrowers, including subprime borrowers.<sup>15</sup>

Part II of this Article describes the background of the emerging predatory lending problem by locating the practice in the broader subprime mortgage lending market, by identifying the emergence of loan terms and practices that the New Jersey legislature concluded were abusive, and by documenting the prevalence and consequences of the predatory lending problem in New Jersey, particularly within low-income and minority communities. Part III provides a detailed analysis of the Act's provisions, demonstrating specifically how it is designed to remedy the problem and highlighting some of its relative strengths and weaknesses. Part IV considers some questions left open by the Act, including whether the Act could be even more aggressive, whether it will hurt the broader subprime lending market and the low-income and minority borrowers who often depend on it, and whether its controversial provisions assigning liability for violations to secondary market purchasers of mortgage notes will have a significant impact on the availability of loans for New Jersey residents.

## II. THE EMERGENCE OF PREDATORY LENDING IN NEW JERSEY

### A. *The Explosion of the Subprime Lending Market*

Predatory lending is a distinct and dangerous subset of the generally positive emergence of subprime lending in the residential mortgage market. A subprime loan is typically intended to extend credit to a borrower who, for reasons such as a poor credit record, high debt-to-income ratio, or unstable employment history, cannot qualify for a conventional or prime mortgage

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13. 15 U.S.C. § 1639 (2000).

14. See N.J. STAT. ANN. § 46:10B-25-26 (West 2003) (prohibiting certain practices in connection with "high cost home loans").

15. § 46:10B-23(2)(b), (c).

loan.<sup>16</sup> Because of the higher costs ostensibly associated with subprime borrowers' greater risk of default, delinquency and foreclosure, subprime loans carry higher interest rates than conventional loans.<sup>17</sup> Studies have estimated that subprime loans have on average a two and a half to four percentage points higher interest rate than prime loans.<sup>18</sup> Subprime lenders also typically charge higher points and fees – charges assessed at the outset of the loan and paid either in cash or financed into the overall loan proceeds – to compensate for higher origination and servicing costs that subprime loans are generally believed to carry.<sup>19</sup> Notwithstanding these increased costs, subprime lending is generally considered to be a welcome development, allowing those traditionally excluded from conventional mortgage borrowing to access credit for home purchases<sup>20</sup> or to access the equity in their homes for other uses.<sup>21</sup>

The subprime lending industry, once virtually nonexistent, has experienced tremendous growth in the past decade. In 1994, only \$35 billion of nationwide loans were subprime, accounting for less than 5% of overall mortgage loan originations. By 1999, subprime lending totaled \$160 billion and its share of overall mortgage originations ballooned to 13%.<sup>22</sup> Subprime

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16. See JOHN C. WEICHER, *THE HOME EQUITY LENDING INDUSTRY: REFINANCING MORTGAGES FOR BORROWERS WITH IMPAIRED CREDIT* 29 (1997).

17. JOINT HUD-TREASURY REPORT, *supra* note 8, at 27-28.

18. *Id.* at 30; see also Cathy L. Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 537 (2000) (describing her study of a cross-section of subprime loans originated between 1996 to 1999 with average interest rates 2.20 to 4.06 percentage points higher than prime loans in a comparable period). Within the subprime market, grades of A-, B, C, and D are assigned to represent progressively higher credit risks carrying correspondingly higher interest rates. See WEICHER, *supra* note 16, at 17 (reporting that subprime loans between the period 1996 to 1999 were on average three percentage points higher than prime loans, but that larger variations between two to six percent existed among grades of subprime loans).

19. WEICHER, *supra* note 16, at 67 (describing higher origination costs and higher servicing costs associated with increased rates of delinquency and foreclosure). It remains unclear, however, whether subprime loans accurately reflect an inherent market risk of default associated with their borrowers or whether overly-costly subprime rates and points and fees actually push borrowers unnecessarily over the brink of default or foreclosure.

20. Ken Zimmerman, Director of New Jersey Institute for Social Justice, Speech at the Seton Hall Law School Predatory Lending Conference (June 17, 2003) (on file with authors).

21. See Glenn B. Canner et al., *Recent Developments in Home Equity Lending*, 84 FED. RES. BULL. 241 (1998) (describing some of the benefits of home equity lending to consumers), available at [www.federalreserve.gov/pubs/bulletin/1998/199804lead.pdf](http://www.federalreserve.gov/pubs/bulletin/1998/199804lead.pdf) (Apr. 1998).

22. JOINT HUD-TREASURY REPORT, *supra* note 8, at 28-29.



lending has continued its dramatic expansion, originating \$200 billion in mortgages in 2002 across the country.<sup>23</sup> New Jersey has witnessed comparable growth. Between 1993 and 2000, the number of subprime loans in New Jersey increased from 2693 to 25,403 and the percentage share of subprime lending in the overall New Jersey mortgage market increased from 1% to 14%.<sup>24</sup>

The causes of this growth are complex and multifaceted. They include the substantial increase in property values – and corresponding availability of leveraged home equity – across the economic spectrum,<sup>25</sup> the tax incentives created by the 1986 Tax Reform Act, which retained solely mortgage interest as a category of tax-deductible consumer interest,<sup>26</sup> and the emergence of nontraditional, nondepository mortgage service providers, such as mortgage brokers, mortgage bankers, finance companies and even home improvement contractors.<sup>27</sup> Perhaps the most important catalyst for the growth of subprime lending, however, has been the correspondingly accelerating process of securitizing subprime mortgages and selling them on the secondary market.<sup>28</sup>

This securitization process has created a long funding pipeline connecting individual residential mortgage borrowers, loan originators (including mortgage brokers, home improvement contractors and an increasing variety of lending institutions), investment banks and investors of all kinds.<sup>29</sup>

On one end of this pipeline, a mortgage broker arranges financing for a borrower from any number of mortgage lenders, such as finance companies,

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23. ROBERT E. LITAN, AM. BANKERS ASS'N, UNINTENDED CONSEQUENCES: THE RISKS OF PREMATURE STATE REGULATION OF PREDATORY LENDING 4 (2003), *available at* <http://www.aba.com/NR/rdonlyres/1FAE5B14-C034-4FF7-8566-664F0BDEDEC/28934/PredReport20093.pdf> (last visited Feb. 24, 2004).

24. KEN ZIMMERMAN ET AL., NEW JERSEY INST. FOR SOC. JUSTICE, PREDATORY LENDING IN NEW JERSEY: THE RISING THREAT TO LOW-INCOME HOMEOWNERS 5-6 (2002), *available at* [http://www.njisj.org/reports/predatory\\_lending.html](http://www.njisj.org/reports/predatory_lending.html) (Feb. 2002).

25. Margo Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111, 119 (2002).

26. Mansfield, *supra* note 18, at 522.

27. JOINT HUD-TREASURY REPORT, *supra* note 8, at 39.

28. *See* Eggert, *supra* note 9, at 534-52. The percentage of subprime mortgages that were securitized and sold on the secondary market increased from 32% in 1994 to 55% in 1998, before dropping to 37% in 1999. JOINT HUD-TREASURY REPORT, *supra* note 8, at 41-42, 42 tbl.3.4.

29. JOINT HUD-TREASURY REPORT, *supra* note 8, at 37-38.

mortgage bankers, banks, thrifts, or credit unions.<sup>30</sup> Mortgage brokers typically charge points or fees for their services and thus make a commission from the total loan amount at closing.<sup>31</sup> In addition, brokers frequently negotiate with lenders to be paid a “yield spread premium,” which represents the difference between the lowest rate the lender proffers the broker to extend to the borrower and the actual rate the broker extends to the borrower. Home improvement contractors often also originate mortgages for borrowers with pre-arranged lenders and are a significant source of abuse in the subprime lending process.<sup>32</sup>

Within this pipeline, an originating lender may hold a loan in its portfolio, collecting monthly mortgage payments as they come due and servicing the loan in all other respects. Most subprime lenders, however, securitize their loans. That is, lenders pool a large group of loans with similar risk grades together, securitize them, and through Wall Street investment banks, sell them to a vast secondary market of loan purchasers that includes institutional investors, mutual funds and pension funds.<sup>33</sup> The enormous growth of securitization has had an utterly transforming effect on the mortgage market. Securitization has simultaneously fueled the growth of subprime lending and the nontraditional – and comparatively underregulated – brokers and finance companies that dominate the market.<sup>34</sup> By selling a loan to the secondary market, a subprime lender does not need to wait to receive monthly mortgage payments from the borrower. It thereby becomes immediately free upon closing to finance a new subprime loan with the proceeds of the sale of the earlier loan.<sup>35</sup> With each financing, a lender collects points and fees and, with each sale to the secondary market, it can

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30. Mortgage brokers now account for almost 50% of all subprime mortgage originations. *The Problem, Impact and Responses: Hearing on Predatory Mortgage Lending Before Senate Comm. on Banking, Housing and Urban Affairs*, 107th Cong. (n.p.) (2001) (statement of Neill Fendly, Immediate Past President, Nat'l Ass'n of Mortgage Brokers), available at [http://www.senate.gov/~banking/01\\_07hr/072701/fendly.htm](http://www.senate.gov/~banking/01_07hr/072701/fendly.htm) (July 27, 2001). Brokers are heavily undercapitalized and, as a result, rarely use their own funds to extend a loan. JOINT HUD-TREASURY REPORT, *supra* note 8, at 39 n.2. Rather, they will typically close the loan in the lender's name; use “table funding” provided by a pre-designated purchaser of the loan; or access a line of credit from a finance company. Eggert, *supra* note 9, at 538.

31. JOINT HUD-TREASURY REPORT, *supra* note 8, at 40.

32. See *infra* text accompanying notes 84-85.

33. JOINT HUD-TREASURY REPORT, *supra* note 8, at 37.

34. Eggert, *supra* note 9, at 546.

35. Engel & McCoy, *supra* note 9, at 1274.

collect an interest point spread which represents the difference between the rate charged to the borrower and the rate offered to investors.<sup>36</sup>

The secondary market seems highly enamored of subprime lending because the rates of return are enormously profitable given the overall risk profile of subprime borrowers.<sup>37</sup> As an added benefit to secondary market investors, and as described below, the secondary market can take advantage of the Holder in Due Course doctrine,<sup>38</sup> which generally immunizes them, as good faith purchasers, from liability for any fraud perpetrated by a loan originator.<sup>39</sup>

### *B. The Predominance of Subprime Lending in Minority Communities*

Subprime lending is concentrated among low and moderate-income borrowers due in part to their typically lower income-to-asset ratios and shorter or weaker credit histories.<sup>40</sup> More troubling, however, is the remarkable predominance of subprime lending in African-American neighborhoods. Nationwide, 50% of all loans in predominantly African-American neighborhoods are subprime, compared to only 9% in

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36. Mansfield, *supra* note 18, at 532.

37. See LITAN, *supra* note 23, at 7; see also *Hearing Before the House Comm. on Banking and Fin. Servs.*, 106th Cong. 10 (2000) [hereinafter *Mansfield Testimony*] (testimony of Cathy Lesser Mansfield) (arguing that many subprime loans carry unjustified and "tremendously inflated costs"); Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency* (Freddie Mac Dec. 21, 2000) (concluding that within the category of A-rated borrowers, subprime loans charged an additional 100 basis points – after discounting heavily for higher default risk and servicing cost – that could not be attributed to borrower credit risk). The Office of the Comptroller of the Currency concluded, however, that earnings of subprime lenders are generally in line with underlying supply and demand fundamentals. COMPTROLLER OF THE CURRENCY ADM'R OF NAT'L BANKS, *ECONOMIC ISSUES IN PREDATORY LENDING* 15 (Office of Comptroller of the Currency, Working Paper, 2003) [hereinafter *OCC Working Paper*], available at [www.occ.treas.gov/workingpaper.pdf](http://www.occ.treas.gov/workingpaper.pdf) (July 30, 2003). The conclusions of the OCC Working Paper have themselves come under severe criticism. See, e.g., NAT'L CONSUMER LAW CTR. ET AL., *COMMENTS TO THE OFFICE OF COMPTROLLER OF CURRENCY, BANKING ACTIVITIES AND OPERATIONS; REAL ESTATE LENDING AND APPRAISALS* (2003), at <http://www.naca.net/CommentsOCCNatBnkPreempt.pdf> (Oct. 6, 2003).

38. See generally U.C.C. § 3-302 (2003); *infra* Part II.E.

39. See *infra* text accompanying notes 119-23.

40. DEP'T OF HOUS. AND URBAN DEV., *UNEQUAL BURDEN: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING IN AMERICA* 3 (2000) [hereinafter *UNEQUAL BURDEN*]. According to this HUD study of 1998 HMDA data, 26% of refinance loans in low-income neighborhoods were subprime compared to a national average of 11% and to 7% in upper income neighborhoods. *Id.* In New Jersey, 60% of lending in low-income areas is subprime. *PREDATORY LENDING IN NEW JERSEY*, *supra* note 24, at 6.

predominantly white neighborhoods.<sup>41</sup> Controlling for income, the racial disparity becomes even more stark: upper income African-Americans are twice as likely as low income white borrowers to receive subprime credit.<sup>42</sup> In New Jersey, controlling for income and other key variables, African-Americans are more than 3 times as likely as white borrowers to receive a subprime home equity loan; they are 2.5 times as likely as white borrowers to receive a subprime purchase money loan to buy a house; finally, they are 1.4 times as likely as white borrowers to receive a subprime refinance loan.<sup>43</sup> These disturbing statistics indicate that much subprime lending is not accurately correlated to credit risk and suggests that a significant portion of subprime lending is predatory: that is, it charges far too high a price for the credit risk presented by an individual borrower.<sup>44</sup>

### C. *The Link Between the Subprime Market and Predatory Lending*

As mentioned, the large majority of subprime loans should not, on its own, be considered predatory. However, certain lending practices, when done in connection with an already expensive subprime loan, are so abusive that they can only be described as predatory. One core feature that these abusive practices have in common is their tendency to strip equity from a borrower without her informed consent.<sup>45</sup> Typical equity stripping practices finance unnecessary charges along with a loan and thereby decrease the value of the borrower's ownership interest in her home.<sup>46</sup> As a result, victims of predatory lending lose their primary – perhaps their only – source of wealth accumulation. In addition, unnecessarily high rates and fees render many unable to consistently make their loan payments and burden them with an unreasonable risk of losing their homes entirely.<sup>47</sup>

These practices, it should be noted, are rarely present in the conventional lending industry. Indeed, they are present only in the predatory subset of the subprime lending market – a subset that has captured a significant share of the subprime market and appears resistant to competition from the legitimate lending market for a variety of reasons. The most fundamental reason is that predatory lenders actively prey on potential

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41. UNEQUAL BURDEN, *supra* note 40, at 3.

42. *Id.*

43. ZIMMERMAN ET AL., *supra* note 24, at 7.

44. See *infra* text accompanying notes 54-57.

45. STEIN, *supra* note 5, at 4.

46. *Id.* at 4-5.

47. *Id.* at 4.

victims: they employ unique, aggressive and often highly misleading marketing and sales techniques.<sup>48</sup> In order to identify potential victims, predatory lenders may search census records to look for predominantly African-American tracts, and/or deed records; to identify persons that either own their homes outright or should have substantial equity in them. They also search tax records to identify delinquent persons who may be in need of money.<sup>49</sup> Predatory lenders and brokers then rely on direct marketing techniques, such as persistent calling or "live checks," which are full of misleading enticements that have proven to be effective with the most vulnerable homeowners. These homeowners tend to be very unsophisticated about mortgage products and largely disconnected from the financial services market.<sup>50</sup> Legitimate subprime and conventional lenders do not, as a matter of course, engage in such aggressive marketing techniques. They tend to attract borrowers who both need credit and are sophisticated enough to price and compare their options.<sup>51</sup>

As one self-confessed predatory lender described in testimony to the U.S. Senate, predatory lenders target "blue-collar workers, people who have not gone to college, older people who are on fixed incomes, non-English-speaking people and people who have significant equity in their homes."<sup>52</sup> Moreover, once a predatory lender has secured a victim, his goal is to keep returning in order to repeatedly flip – refinance – the victim's loan, churning additional fees and stripping additional equity each time.<sup>53</sup> However, once a borrower has been trapped in an equity-stripping loan, her loan-to-value ratio is likely too high to ever allow her to trade up to legitimate subprime financing.

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48. ASS'N OF CMTY. ORGS. FOR REFORM NOW (ACORN), *SEPARATE AND UNEQUAL: PREDATORY LENDING IN AMERICA* 34-35 (2002) [hereinafter *SEPARATE AND UNEQUAL*], available at <http://www.acorn.org/acorn10/predatorylending/plreports/SU2002/main.pdf> (Nov. 2002).

49. *Id.*

50. *Id.*; see also Eggert, *supra* note 9, at 516.

51. Engel & McCoy, *supra* note 9, at 1289-90.

52. *Equity Predators: Stripping, Flipping and Packing Their Way to Profits: Hearing Before the Senate Special Comm. on Aging*, 105th Cong. (n.p.) (1998) [hereinafter *Testimony of Jim Dough*] (statement of "Jim Dough," Anonymous Employee, Finance Co.) ("[M]y perfect customer would be an uneducated widow who is on a fixed income – hopefully from her deceased husband's pension and social security – who has her house paid off, is living off of credit cards, but having a difficult time keeping up her payments, and who must make a car payment in addition to her credit card payments."), available at <http://aging.senate.gov/events/hr14jd.htm> (Mar. 16, 1998).

53. See *infra* text accompanying notes 72-75.

Some of the most common and most damaging equity-stripping or otherwise unreasonable lending practices are:

1. Lending without Regard to Ability to Repay

Predatory lenders often make a loan based upon the value of the equity that the borrower has in the home, but without concern for whether the borrower has enough income to support monthly mortgage payments. The practice is sometimes referred to as "asset-based lending."<sup>54</sup> This practice predictably sets up a borrower for default and eventual loss of her home. Though foreclosure is typically costly and disfavored by legitimate mortgage lenders,<sup>55</sup> participants in the predatory lending pipeline may be unconcerned with the likelihood of foreclosure on these loans because they have already received their benefit. Mortgage brokers will have received a commission at the outset from the loan proceeds (and have been known to exaggerate a borrower's credentials when presenting an application for lender approval); a lender can then immediately securitize and sell the loan to the secondary market and recover the value of the loan immediately; and the secondary market investor can still recoup losses because the asset-based lending is typically directed at borrowers who already have substantial equity in their homes.<sup>56</sup> As we shall see below, HOSA does not expressly address this practice.<sup>57</sup>

2. Financing Excessive Points and Fees

Points and fees charged in connection with predatory loans routinely amount to between 5% and 8% of the loan amount.<sup>58</sup> Points and fees can become even costlier because they are not paid in cash by the borrower but, rather, frequently are financed as part of the total loan amount. As a result, a subprime borrower will pay the already high interest rate associated with her

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54. JOINT HUD-TREASURY REPORT, *supra* note 8, at 76.

55. WEICHER, *supra* note 16, at 84.

56. Eggert, *supra* note 9, at 550-60.

57. See *infra* text accompanying notes 240-43.

58. STEIN, *supra* note 5, at 7 (estimating that 750,000 loans annually have points and fees that are in excess of 5% of the total loan value); see also SEPARATE AND UNEQUAL, *supra* note 48, at 37 (reporting that borrowers in predatory loans are "routinely" charged just under 8% of the loan amount in points and fees). By contrast, the average points and fees charged on conventional loans, if any are charged, is 1.1%. *Id.*

loan to finance the points and fees.<sup>59</sup> Financing points and fees can be dangerous because their costs are not transparent; such financing tends to obscure the true cost of the loan, particularly when many borrowers do not find out about the financing process until the closing.<sup>60</sup> Financing of points and fees can be particularly abusive when combined with other equity stripping devices such as loan flipping, which is described below.

### 3. Prepayment Penalties

Prepayment penalties are charges a borrower must pay if she wishes to pay off or refinance a loan, either through the same lender or a different one, before the end of the loan term.<sup>61</sup> Prepayment penalties are virtually nonexistent in the prime industry due to competition.<sup>62</sup> Seventy percent of loans in the subprime market, however, contain prepayment penalties of approximately 5% of the total loan amount.<sup>63</sup> Because prepayment penalties in a refinance are typically financed as part of the new loan rather than paid at closing, they drive up the cost of the new loan and thereby deplete a borrower's equity.<sup>64</sup> They are particularly objectionable where, as is frequently the case, a borrower was not aware of the prepayment provision in her initial loan.<sup>65</sup> Because an existing New Jersey statute generally prohibits the imposition of prepayment penalties in connection with residential mortgages,<sup>66</sup> HOSA does not directly limit the imposition of

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59. *Mansfield Testimony*, *supra* note 37 ("[T]he combination of high points and fees in a refinance loan and high rates translate into exorbitantly higher costs for the borrower – much higher than they would be if the borrower were lent the second mortgage or unsecured credit product he/she sought in the first place.").

60. STEIN, *supra* note 5, at 4; *see also* Zimmerman, *supra* note 20.

61. JOINT HUD-TREASURY REPORT, *supra* note 8, at 94-95; DEBBIE GOLDSTEIN & STACY STROHAUER SON, CTR. FOR RESPONSIBLE LENDING, WHY PREPAYMENT PENALTIES ARE ABUSIVE IN SUBPRIME HOME LOANS (2003), *available at* [http://www.responsiblelending.org/pdfs/PPP\\_Policy\\_Paper2.pdf](http://www.responsiblelending.org/pdfs/PPP_Policy_Paper2.pdf) (Apr. 2, 2003).

62. Joshua Brockman, *Fannie Revamps Prepayment-Penalty Bonds*, Mortgage-Backed Securities Letter, July 26, 1999, at 16 (noting that in conventional conforming market prepayment penalties are assessed on less than two percent of borrowers).

63. JOINT HUD-TREASURY REPORT, *supra* note 8, at 92.

64. COST OF PREDATORY LENDING, *supra* note 5, at 9 (estimating that prepayment penalties on subprime loans cost U.S. borrowers \$2.3 billion a year); *see also* GOLDSTEIN & SON, *supra* note 61, at 5.

65. GOLDSTEIN & SON, *supra* note 61, at 4.

66. N.J. STAT. ANN. § 46:10B-1 to -11.1 (West 2003). *But see* Shinn v. Encore Mortgage Servs., Inc., 96 F. Supp. 2d 419 (D.N.J. 2000) (holding that the Federal Alternative

prepayment penalties. HOSA does, however, indirectly address the issue by putting a cap on the number of points that can be refinanced in connection with high cost loans.

#### 4. Packing Single Premium Insurance Products

Predatory lenders often “pack” unnecessary and costly insurance products to pay off the borrower’s loan in the event of sickness, disability or death, into subprime loans and finance them without the borrower’s informed consent.<sup>67</sup> Unlike traditional insurance premiums, which are paid on a monthly basis, subprime mortgage insurance products are frequently sold as “single premium” in which five years worth of premiums are paid up front in one lump sum and financed over the (usually longer) term of the loan. Such financing of single premium credit insurance is estimated to cost up to four to five times as much as does unfinanced credit insurance paid periodically by the borrower<sup>68</sup> and is rarely properly disclosed to the borrower.<sup>69</sup> Indeed, leading consumer advocacy groups consider the

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Mortgage Transactions Parity Act of 1982 preempts section 46:10B-1 as to adjustable rate mortgages, thereby allowing the imposition of prepayment penalties for such mortgages).

67. N.J. STAT. ANN. § 46:10B-2 (“Prepayment of a mortgage loan may be made by or on behalf of a mortgagor at any time without penalty.”). The New Jersey prepayment statute is preempted as to federal savings associations, which may impose prepayment penalties. 12 C.F.R. § 545.2 (2004) (preempting state laws addressing operations of federal savings associations); *id.* § 560.34 (authorizing federal savings associations to impose prepayment penalties). The New Jersey prepayment statute is also preempted as to national credit unions, but they may not impose prepayment penalties under their own regulations. *Id.* § 701.21(b) (preempting state laws addressing terms of repayment for national credit union loans); 12 U.S.C. § 1757(5)(A)(viii) (2000) (barring national credit unions from imposing prepayment penalties). The New Jersey prepayment statute is preempted as to national banks, which may charge non-interest fees, such as prepayment penalties. 12 C.F.R. § 7.4002(d) (preempting state laws that limit or prohibit charges by national banks); *id.* § 7.4002(a) (allowing national banks to charge non-interest fees). Prior to July 1, 2003, the New Jersey prepayment statute was also preempted as to state-chartered housing creditors. *Compare id.* § 560.220, with 12 C.F.R. § 560.220 (2002); *see* 67 Fed. Reg. 76,304 (2002) (delaying effective date of revision of § 560.220 from January 1, 2003 to July 1, 2003); *see also* *Glukowsky v. Equity One, Inc.*, 848 A.2d 747 (N.J. 2004) (finding, *in dicta*, that revised section 560.220 does not preempt section 46:10B-2 of the New Jersey Statutes Annotated as to state-chartered housing creditors).

68. SEPARATE AND UNEQUAL, *supra* note 48, at 42. In addition, lenders have strong incentives to pack such insurance products because they receive an average of 30% commission from the insurance company on the sale. STEIN, *supra* note 5, at 7.

69. STEIN, *supra* note 5, at 6.



financing of single premium credit insurance to be nothing less than a "rip-off."<sup>70</sup>

### 5. Loan Flipping

Loan flipping refers to the practice of repeatedly refinancing a borrower's loan (typically within the first few years of the loan term) with a fee-loaded loan, without reasonable benefit to the borrower.<sup>71</sup> Subprime borrowers are frequently solicited to refinance by predatory lenders with assurances that their monthly payments will be lower (by extending the loan term) or with suggestions that they could use cash to consolidate other consumer debts. The refinancings typically contain high points and fees as well as prepayment penalties, which provide additional revenue to lenders and brokers, but materially deplete the equity that borrowers retain in their homes.<sup>72</sup> Flipping depends on the skill and confidence of individual lender representatives or brokers, who are persistent in winning the trust of consumers and otherwise assuring them that the time is especially right to take advantage of refinancing.<sup>73</sup> Indeed, loan flipping is a core weapon in the predatory lenders' arsenal. A predatory lender's ultimate goal is to lock a borrower into one abusive loan, and return over and over to the borrower to siphon equity out of her home and into their own pockets.<sup>74</sup> Once a

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70. CONSUMER FED'N OF AM. AND CTR. FOR ECON. JUSTICE, CREDIT INSURANCE OVERCHARGES HIT \$2.5 BILLION ANNUALLY (2001), available at <http://www.consumerfed.org/credins.pdf> (Nov. 2001); CONSUMERS UNION & CTR. FOR ECON. JUSTICE, CREDIT INSURANCE: THE \$2 BILLION A YEAR RIP-OFF (1999), available at <http://www.consumersunion.org/pdf/credit.pdf> (Mar. 1999).

71. JOINT HUD-TREASURY REPORT, *supra* note 8, at 75.

72. For example, in *Cammarano v. Associates*, Civ. No. F-13509-97 (N.J. Super. Ct. Ch. Div. 1997), a woman obtained a \$28,000 home equity loan from Associates. After Ms. Cammarano had difficulty making her payments, Associates initiated contact with her and refinanced the loan three times in two years, increasing her total indebtedness to \$56,000, which was primarily comprised of refinanced points and fees. *Id.*

73. See Engel & McCoy, *supra* note 9, at 1283 ("Predatory lenders . . . endear themselves with charm and guile. They consciously exude an aura of expertise and success, intimidating customers from questioning the advisability of the loans they are offering.").

74. See, e.g., *Testimony of Jim Dough*, *supra* note 52. Jim Dough also testified that predatory finance companies

require branch employees to make contact every three months with customers to prevent payoffs and up-sell to bigger loans. At some of my branches, we tried to call every one of our real estate customers at least once a month. The purpose of these contacts was to flip as many loans as possible. Our tactic was to try to gain the trust and confidence of the customer.

*Id.*

borrower is trapped in this equity-depleting cycle, it becomes increasingly difficult to escape through refinancing with a legitimate lender on favorable terms.

#### 6. Balloon Payments, Advance Payments, Default Interest Rates and Discretionary Call Provisions

Traditionally, a balloon payment is a lump sum payment that is due near the end of the fixed loan repayment term, and which pays off the remainder of a borrower's unpaid principle.<sup>75</sup> In the predatory market, unlike in the conventional market, a balloon payment may come due after a very short period – frequently within three to five years – and therefore represent an amount nearly equal to the original principal balance.<sup>76</sup> Victims of predatory lending are often either deceived about the existence of a balloon provision in their loan or are falsely reassured that they could simply refinance this exorbitant balloon payment at a lower rate in the future. In fact, predatory lenders will use an impending balloon payment to coerce the borrower to refinance the loan – i.e. flip the borrower – so that the lender can extract additional points and fees.<sup>77</sup>

Advance payment provisions require that borrowers prepay a certain amount of interest at closing that would otherwise be payable over the course of the loan.<sup>78</sup> Default interest rate provisions substantially increase the interest rate owed upon any default – sometimes by amounts up to 40%. These provisions can be deeply unfair because they make it very difficult for a borrower to cure a default; indeed, they position a borrower for a quick foreclosure or refinancing at outrageous terms.<sup>79</sup> Call provisions allow lenders to demand payment of the full loan amount at the lenders' sole discretion and thereby offer lenders overwhelming leverage over borrowers.<sup>80</sup> All three provisions are typically included without the borrowers' knowledge or understanding.<sup>81</sup> These provisions also provide

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75. JOINT HUD-TREASURY REPORT, *supra* note 8, at 96.

76. *Id.*

77. SEPARATE AND UNEQUAL, *supra* note 48, at 41.

78. See NAT'L CONSUMER LAW CTR., STOP PREDATORY LENDING: A GUIDE FOR LEGAL ADVOCATES 46 (2002) (noting that "[s]ome lenders collect these payments upfront at closing to disguise the real amount of credit extended and to increase the consumer's obligation to pay interest").

79. NAT'L CONSUMER LAW CTR., TRUTH IN LENDING § 10.4.3 (4th ed. 1999) [hereinafter TRUTH IN LENDING].

80. SEPARATE AND UNEQUAL, *supra* note 48, at 40.

81. *Id.*

unscrupulous lenders with an opportunity to initiate contact and the leverage to coerce borrowers to refinance with another high-fee loan so as to avoid the application of the abusive terms.

### 7. Negative Amortization

Most loans amortize over the life of the loan with a resultant diminution of principal. Negative amortization, by contrast, is a type of loan structure in which the monthly payments do not even cover interest charges, causing the principal to increase – rather than decrease – over the life of the loan.<sup>82</sup> Because negative amortization causes a borrower to steadily lose equity each month, it is virtually never in a borrower's interest to accept such a loan term. Not surprisingly, however, many borrowers report that their lenders did not explain how such a loan structure would work.<sup>83</sup>

### 8. Home Improvement Contractor Abuse

Unscrupulous home improvement contractors frequently pass through poor and minority neighborhoods looking for homes that are in disrepair and therefore susceptible to a home-improvement pitch.<sup>84</sup> The contractors will offer to arrange financing with a pre-arranged lender who agrees to pay the contractor directly from the loan proceeds. Because the borrower is not directly paying the contractor, the borrower has no leverage over the timing or quality of the contractor's work. As a result, these contractors can walk away with substantial payments, leaving the promised repairs unfinished, shabbily done or even unattempted, abandoning the borrower with an unwanted and abusive home equity loan from the complicit lender.<sup>85</sup>

### *D. Predatory Lending's Wake: An Epidemic of Foreclosures*

Predatory lending has real, measurable negative consequences, which are significantly more than those associated with other types of consumer fraud. The practice has precipitated a rash of foreclosures in New Jersey, causing devastating financial and emotional harm to individual victims, particularly those in low-income and minority neighborhoods where predatory practices are concentrated. For example, in Essex County, New

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82. JOINT HUD-TREASURY REPORT, *supra* note 8, at 91.

83. SEPARATE AND UNEQUAL, *supra* note 49, at 41.

84. *Id.* at 39.

85. JOINT HUD-TREASURY REPORT, *supra* note 8, at 39.

Jersey, the number of residential foreclosures increased from 1701 in 1995 to 2516 in 2000, as the percentage share of those foreclosures attributable to subprime loans increased from 18.8% to 29.6%.<sup>86</sup> Significantly, the data appear to demonstrate that foreclosures have not merely tracked the increase in overall subprime lending, but rather that subprime and predatory lending have prematurely *caused* disproportionately greater numbers of foreclosures. For example, between 1995 and 2000, the rate of subprime foreclosures was double the rate of subprime originations in northern New Jersey counties.<sup>87</sup> At the same time, the speed at which loans went into foreclosure – a result of loans that were unmanageable from the start or were subject to serious equity stripping practices – increased dramatically. The average age of a loan in foreclosure dropped from 6.7 years in 1995 to 4.0 years half a decade later.<sup>88</sup> The highest concentrations of defaults are in largely African-American sections of southern and western Newark, Irvington and East Orange.<sup>89</sup>

A foreclosure on a residential home puts a family through a period of devastating emotional and financial distress.<sup>90</sup> In addition, when foreclosures are concentrated in particular neighborhoods, once-healthy communities suffer from the externalities associated with largely abandoned tracts of land: a decrease in overall property values, an increase in crime, and a corresponding need for greater law enforcement and other government services.<sup>91</sup>

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86. ZIMMERMAN ET AL., *supra* note 24, at 8. In the first half of 2001, foreclosures increased an additional 15%. *Id.* According to the study, these figures are significantly understated because they do not take into account foreclosures accomplished by secondary holders of mortgage notes, which represent approximately half of all subprime mortgage note holders. *Id.*

87. *Id.*; cf. JOINT CTR. FOR HOUS. STUDIES, HARVARD UNIV., CREDIT, CAPITAL AND COMMUNITIES: THE IMPLICATIONS OF THE CHANGING MORTGAGE BANKING INDUSTRY FOR COMMUNITY BASED ORGANIZATIONS (2004) (“Best available data suggest that in 2002, subprime loans had a serious delinquency rate of 10.44 percent, nearly 20 times higher than the rate for prime conventional loans.”), *available at* <http://www.jchs.harvard.edu/publications/communitydevelopment/ccc04-1.pdf> (Mar. 9, 2004).

88. ZIMMERMAN ET AL., *supra* note 24, at 6, 8.

89. *Id.* at 8.

90. WEICHER, *supra* note 16, at 84 (acknowledging that the consequences of home foreclosure can be tragic, such as the loss of a home that may represent all the assets of a family, the necessity of uprooting the family and moving to a less desirable residence); Eggert, *supra* note 9, at 581 (describing the range of devastating emotions and problems encountered by families subjected to home foreclosure).

91. Ayse Can, *GIS and Spatial Analysis of Housing and Mortgage Markets*, 9 J. HOUS. RES. 61, 68 (1998), *available at* <http://www.fanniemaefoundation.org/programs/jhr/pdf/>

The explosion of foreclosures caused by predatory lending appears more lamentable when one considers that the vast majority of victims of predatory lending already owned their homes. Over 80% of subprime lending – the market within which predatory lending occurs – is not for the purchase of a home but, rather, primarily for cash-out refinancings or to consolidate pre-existing consumer debt.<sup>92</sup> Thus, many homeowners are losing their houses because new and complex forms of consumer debt products, secured by mortgages on their home, have been sold to them on utterly unreasonable and confusing terms.<sup>93</sup>

### *E. The Limitations of Pre-HOSA Remedies*

In enacting HOSA, New Jersey recognized that the phenomenon of predatory lending was too broad and persistent to be controlled by existing remedies. New Jersey tort remedies typically reach only outright misrepresentation by lenders. Federal disclosure statutes, such as the Truth in Lending Act (TILA),<sup>94</sup> remain ineffective in warning borrowers about all the pitfalls of predatory loans. Finally, the federal high cost home loan statute upon which HOSA builds – the HOEPA<sup>95</sup> – encompasses too few home loans within its regulatory scope to have much impact on the predatory lending phenomenon. Moreover, much of the effectiveness of these remedies is actually eliminated by the Holder in Due Course doctrine, which largely insulates good faith purchasers of predatory loans from liability for the illegal conduct of such loans' originators. As described below, HOSA increases loan disclosure requirements, bolsters current consumer fraud protections in the home loan area, supplements protections for classes of high cost loans and, very importantly, eliminates in many cases the liability barriers posed by the Holder in Due Course doctrine.

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jhr\_0901\_can.pdf (last visited May 24, 2004); *Equity Predators: Stripping, Flipping and Packing Their Way to Profits: Hearing Before the Senate Special Committee on Aging*, 105th Cong. 105-18 (1998) (statement of William J. Brennan, Jr., Director, Home Defense Program of the Atlanta Legal Aid Society, Inc.), available at <http://aging.senate.gov/events/hr14wb.htm> (Mar. 16, 1998).

92. Of the 80% of subprime loans that are used for refinancing, 59% are cash-out loans. JOINT HUD-TREASURY REPORT, *supra* note 8, at 31.

93. *Mansfield Testimony*, *supra* note 37 (emphasizing that a large proportion of subprime foreclosures result from subprime debt consolidation refinancings that were misunderstood by the borrower, were not really needed or were issued on unfair terms).

94. 15 U.S.C. § 1602 (2000).

95. § 1601.

### 1. Pre-HOSA Remedies

The New Jersey Consumer Fraud Act (CFA),<sup>96</sup> though considered one of the most consumer-friendly statutes in the nation,<sup>97</sup> only applies to misrepresentations, material omissions, or overall unconscionable conduct.<sup>98</sup> While such conduct is obviously present in many predatory loans (though notoriously difficult to prove), the CFA does not appear to specifically prohibit common predatory practices such as asset-based lending, loan flipping, insurance fee packing, and financing excessive points and fees in a consistent or predictable manner – particularly in the absence of proof of fraud or deception.<sup>99</sup> In addition, claims under the CFA cannot be asserted against the substantial number of secondary market holders of predatory mortgage notes (at least in the absence of actual or constructive knowledge), either as an affirmative claim or as a defense to foreclosure because the Holder in Due Course doctrine immunizes a good faith purchaser of a note from most claims that could have been asserted against a loan originator, no matter how meritorious the underlying claim.<sup>100</sup>

The Federal Truth in Lending Act mandates certain important disclosures in connection with a home loan including the annual percentage rate (APR), the total amount financed which must include a calculation of points and fees charged, and the monthly payment amount and number of payments necessary to pay off the loan entirely.<sup>101</sup> It authorizes actual damages, statutory damages of double the finance charge and attorneys fees for any violations.<sup>102</sup> However, in the fight against predatory lending, TILA offers too little too late. It fails to include more obvious and less technical disclosures that traditionally unsophisticated victims of predatory lending need. In addition, the disclosures that TILA does require need only be made at the loan closing when a borrower has already psychologically

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96. N.J. STAT. ANN. § 56:8-2 (West 2001).

97. *Cox v. Sears Roebuck & Co.*, 647 A.2d 454, 460-61 (N.J. 1994) (noting that New Jersey has “one of the strongest consumer protection laws in the nation” and that it “should be construed liberally in favor of consumers”). The Consumer Fraud Act mandates treble damages and attorneys fees. § 56:8-19.

98. *Lemelledo v. Beneficial Mgmt. Corp. of Am.*, 674 A.2d 582 (N.J. 1996).

99. *Cf. Assocs. Home Equity Servs. v. Troup*, 778 A.2d 529, 544 (N.J. Super. Ct. App. Div. 2001) (holding that defendants raised genuine issues of material fact regarding unconscionability of residential mortgage terms in Consumer Fraud Act counterclaim).

100. *See infra* text accompanying notes 118-24.

101. 15 U.S.C. § 1638 (2000).

102. § 1640(a)(1)-(3).

committed.<sup>103</sup> The disclosures are also too confusing where they come included in a bewildering stack of loan documents. In sum, TILA is not sufficient, standing alone, to warn vulnerable borrowers about the true costs of a loan.

Finally, in 1994, Congress enacted HOEPA, an amendment to TILA, which places direct limits on certain practices if made in connection with a "high cost loan."<sup>104</sup> Specifically, HOEPA protections apply if a loan meets one of two high cost loan triggers: (i) the "rate trigger" or "APR trigger," where the APR exceeds by 8% the yield on Treasury securities of comparable maturity for first lien loans (or above 10% for subordinate lien loans); or (ii) the "fee-trigger," where the total of the loan's points and fees exceeds 8% of the loan total or \$400 (adjusted for inflation), whichever is greater.<sup>105</sup> Regulation Z, promulgated under HOEPA by the Federal Reserve Board, specifies which charges count as points and fees for purposes of the fee trigger and includes compensation to a mortgage broker in the form of a yield spread premium,<sup>106</sup> after recent amendments to Regulation Z, optional credit insurance is also included in the calculation of points and fees.<sup>107</sup>

HOEPA prohibits the inclusion in high cost loans of certain loan terms that tend to be abusive. For such high cost loans, HOEPA prohibits negative amortization without exception,<sup>108</sup> balloon payments on loans with terms of less than five years,<sup>109</sup> loan terms that increase the interest rate in the event of a default,<sup>110</sup> and prepayment penalties in certain cases for financially vulnerable borrowers.<sup>111</sup> HOEPA creditors are prohibited from engaging in

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103. Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth In Lending Act*, 55 FLA. L. REV. 807, 898 (2003).

104. 15 U.S.C. § 1601.

105. § 1602(aa)(1), (3); 12 C.F.R. § 226.32(a)(1)(i) (2002). The fee trigger was lowered by the Federal Reserve Board in 2001 (with compliance mandatory by October 1, 2002), from 10% above comparable Treasury securities (for either first or second lien loans). 66 Fed. Reg. 65,606, 65,608-610 (Dec. 20, 2001).

106. 15 U.S.C. § 1602(aa)(4)(B); 12 C.F.R. § 226.32(b)(1)(ii).

107. 12 C.F.R. § 226.32(a)(1)(ii), (b)(1)(iv). Real estate charges such as title insurance, filing and recording fees must also be included unless the charges are reasonable, offer no direct or indirect compensation to the creditor, and are paid to a third party unaffiliated with the creditor. § 226.32(b)(1)(iii).

108. 15 U.S.C. § 1539(f); 12 C.F.R. § 226.32(d)(2).

109. 15 U.S.C. § 1639(e); 12 C.F.R. § 226.32(c)(3), (d)(1) (Official Staff Commentary). For loan terms that exceed five years, balloon payments are permissible, but must be disclosed. *Id.* § 226.32(c)(3).

110. 15 U.S.C. § 1639(d); 12 C.F.R. § 226.32(d)(4).

111. 15 U.S.C. § 1639(c)(1)(A); 12 C.F.R. § 226.32(d)(6). Prepayment penalties are permitted only if: (i) the loan will not cause the borrower to pay more than 50% of his income

asset-based lending – lending without regard to a borrower's ability to pay<sup>112</sup> – but only if they have engaged in a “pattern or practice” of such activity.<sup>113</sup> Recent amendments to Regulation Z also place limits on loan flipping: Creditors or their affiliates are forbidden from refinancing a HOEPA-covered loan within a year, unless the refinancing is “in the borrower's interest.”<sup>114</sup> Damages for violations of HOEPA include all those available under TILA plus enhanced statutory damages in the amount of the sum of all finance charges and fees paid by the consumer.<sup>115</sup>

HOEPA's scope, however, is narrow in two important respects. First, HOEPA does not cover purchase money mortgages (those used to purchase homes) or open-end lines of credit (such as home equity lines of credit).<sup>116</sup> Moreover, as consumer advocates have been arguing for years, the HOEPA high cost loan triggers are too high. Predatory lenders are notoriously

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to the monthly payments; (ii) income and expenses are verified by financial statements signed by the consumer and supported by a credit report; (iii) creditor is not refinancing one of its own or an affiliate's loans; (iv) if it occurs within the first five years of the loan; and (v) the penalty is legal under state law. 15 U.S.C. § 1639(c).

112. § 1639(h). HOEPA defines this conduct as extending credit “based on the consumer's collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations, and employment.” *Id.*

113. *Newton v. United Co. Fin. Corp.*, 24 F. Supp. 2d 444, 451 (E.D. Pa. 1998). Traditionally, the pattern or practice element of the prohibition has been a hard one for plaintiffs to satisfy, requiring proof of several instances of prohibited conduct in a short period of time. *Id.* at 457. The recent amendments have loosened the requirement somewhat, creating a presumptive violation where the lender has failed to document and verify the borrower's ability to pay. 66 Fed. Reg. 65,606, 65,608-610 (Dec. 20, 2001) (to be codified at 12 C.F.R. pt. 226).

114. 12 C.F.R. § 226.34(a)(3) (2003). In considering whether a refinancing is in the borrower's interest, Regulation Z instructs lenders to consider the totality of the borrower's circumstances at the time the credit was extended. *Id.* (Official Staff Commentary).

115. 15 U.S.C. § 1640(a). HOEPA, like TILA, has a one-year statute of limitations for affirmative suits, but can be raised any time – including against assignees – as a defense to foreclosure. *Id.* § 1640(e).

116. Open-end credit is a credit extension where the exact amount of money lent or advanced at any given time is not fixed. *Id.* § 1602(i). It is, in short, a line of credit. In order to qualify as an open-end loan, TILA and Regulation Z require that creditors demonstrate that their credit plan meets three specific elements. *Id.* A creditor under a plan: (i) must reasonably contemplate repeated transactions; (ii) may impose a finance charge from time to time on an outstanding unpaid balance; and (iii) generally replenishes the amount of credit available to the consumer to the extent that any outstanding balance is repaid. *Id.*; 12 C.F.R. § 226.2(a)(20). Open-end lines of credit are being used to avoid HOEPA regulation. TRUTH IN LENDING, *supra* note 80, at § 9.2.4.3.



successful at offering loans with rates or points and fees just below the high HOEPA triggers and thereby evading regulation.<sup>117</sup>

## 2. Holder in Due Course Doctrine's Elimination of Assignee Liability

A significant limitation on remedies available to victims of predatory lending is the Holder in Due Course doctrine, codified in the Uniform Commercial Code.<sup>118</sup> The doctrine insulates noteholders in the secondary market from most defenses, including fraud-related ones, that the borrower could have raised against the original creditor.<sup>119</sup> The Federal Trade Commission (FTC) has fully abrogated the Holder in Due Course doctrine's application to the sale of consumer goods; this abrogation makes the doctrine unavailable to assignees of loans involving manufactured homes or home improvements.<sup>120</sup> Similarly, HOEPA has abrogated the doctrine for loans it covers, making good faith assignees potentially liable for all claims and subject to all defenses a debtor could have raised against the loan originator, unless the assignee can demonstrate that "a reasonable person exercising ordinary due diligence" could not have determined that the loan was covered by HOEPA.<sup>121</sup>

Nevertheless, in the large category of non-HOEPA home purchase or refinance loans that are sold to the secondary market, the Holder in Due Course doctrine poses a substantial impediment to borrowers seeking redress for predatory loans, and likewise renders them virtually helpless to contest foreclosures of predatory loans brought by secondary market mortgage noteholders.<sup>122</sup> As a result, the Holder in Due Course doctrine creates little

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117. JOINT HUD-TREASURY REPORT, *supra* note 8, at 84; TRUTH IN LENDING, *supra* note 79, at § 10.1.1.

118. U.C.C. § 3-302 (2003). The rule applies to purchasers of mortgages if they are: (1) a holder; (2) of a negotiable note; (3) who took the note for value; (4) in good faith; (5) without notice of the defenses to the note. See JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 14-2 (4th ed. 1995).

119. The only "real" defenses that survive the protections for good faith noteholders are severely limited. They include infancy, duress, lack of legal capacity illegality of transaction, or fraud in the factum involving, for example, a forged signature. WHITE AND SUMMERS, *supra* note 118, § 14-10.

120. FTC Holder in Due Course Regulations, 16 C.F.R. § 433.2.

121. 15 U.S.C. § 1641(d)(1). Due diligence requires that the purchaser examine all loan documentation required by TILA; the itemization of the amount financed; and any other disclosures. TRUTH IN LENDING, *supra* note 79, § 10.7.2.

122. See Eggert, *supra* note 9, at 612-14 (discussing the substantial costs both securitization and the Holder in Due Course Rule have imposed on borrowers in the subprime mortgage market).

incentive for the secondary market to police predatory practices of loan originators. Consumer advocates have persistently argued, therefore, that any effective remedy for predatory lending must include a provision that imposes liability against assignees of abusive loans both to offer borrowers protection against foreclosure and to force the secondary market to cut off funding to predatory lenders.<sup>123</sup>

### III. THE NEW JERSEY HOME OWNERSHIP SECURITY ACT: ATTEMPTING TO CURB THE WORST AND PROTECT THE BEST OF THE SUBPRIME MARKET

On May 1, 2003, Governor James McGreevey signed the New Jersey Home Ownership Security Act (HOSA or the Act) into law.<sup>124</sup> It applies to most New Jersey purchase money and home equity loans that close on or after November 27, 2003.<sup>125</sup> The stated purpose of the Act is to “encourage lending at reasonable rates with reasonable terms” so as to strengthen the viability of many communities and increase home ownership.<sup>126</sup> Modeled in significant respects on HOEPA, HOSA is designed to accomplish this goal by prohibiting certain mortgage lending terms and practices deemed either categorically unjustifiable or abusive when made in connection with loans that already have very high interest rates or points and fees. Consumer advocates consider the Act a landmark measure that will protect New Jersey’s most financially vulnerable homeowners from predatory lenders and offer a reprieve against the rash of unfair home foreclosures that are concentrated in New Jersey’s minority and low-income neighborhoods.<sup>127</sup>

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123. See, e.g., *id.* at 617:

[T]he surest solution to the problem of predatory lending is to force the markets that fund subprime lenders to police those lenders, and the surest way to force this private policing effort is to ensure that the buyers of predatory loans bear any risk of loss associated with the sharp practices by the lender, rather than having that loss borne by the borrower.

124. N.J. STAT. ANN. § 46:10B-22 to -35 (West 2003).

125. *Id.* § 46:10B-35; see also *id.* § 46:10B-31; H. ROBERT TILLMAN, N.J. DEP’T OF BANKING AND INS., BULLETIN NO. 03-15 (2003), [hereinafter BULLETIN NO. 03-15], available at [http://www.state.nj.us/dobi/bulletins/blt03\\_15.pdf](http://www.state.nj.us/dobi/bulletins/blt03_15.pdf) (July 25, 2003).

126. § 46:10B-23(2)(b)-(c).

127. See, e.g., Ken Zimmerman & Linda Fisher, *Progress in the Fight against Predatory Lending*, STAR-LEDGER, May 16, 2003, at 23; see also Editorial, *Predatory Lending*, N.J. L.J., May 12, 2003, at 30 (describing the act as a “national model in state legislative efforts to combat the range of abusive mortgage lending practices collectively referred to as predatory lending”); MBANJ Backs Compromise, ORIGINATION NEWS, Apr. 2003, available at <http://www.acorn.org/campaigns/pc.php?p=2111>.

Representatives of the subprime lending industry argue that the Act is unnecessary in light of existing remedies and may even be counterproductive, but nevertheless agree that the Act will significantly alter subprime lending practices in the state.<sup>128</sup> Industry representatives also argue that the Act is ambiguous and fails to give creditors sufficient guidance as to how they should comply with the new law.<sup>129</sup> The subprime lending industry has looked to the New Jersey Department of Banking and Insurance (DOBI) for additional guidance. But, while the New Jersey legislature has given DOBI significant investigatory and enforcement powers under the Act,<sup>130</sup> it has granted DOBI only limited regulatory authority to interpret the Act.<sup>131</sup>

Indeed, DOBI has only been authorized to promulgate regulations to effectuate the Act's provisions relating to: (i) mandatory disclosure notices and loan counseling programs for prospective High Cost Home Loan borrowers and (ii) additional consumer counseling and awareness programs for all prospective Home Loan borrowers.<sup>132</sup> DOBI, notwithstanding its lack of direct statutory authority, has issued bulletins to provide guidance to potential creditors as to the meaning of a number of the Act's ambiguous

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128. See, e.g., Jim Goryeb, *Loan Law Is a Bad Risk for Jersey*, STAR-LEDGER, May 9, 2003, at 31, available at 2003 WL 19921382.

129. See, e.g., GEOFFREY M. CONNOR ET AL., REED SMITH, LLP, A.75 NEW JERSEY'S NEW ANTI-PREDATORY LENDING LAW (2003), available at <http://www.reedsmith.com/library/publicationView.cfm?itemid=33130> (May 8, 2003).

130. The Act provides DOBI with significant investigatory powers. See N.J. STAT. ANN. § 46:10B-28(7)(a)-(c) (West 2003). It also provides DOBI with substantial remedial powers for violations of the Act, including authority to: (1) impose civil penalties of up to \$10,000 for each offense; (2) suspend, revoke or refuse to renew any license issued by DOBI; (3) remove a person responsible for a violation of the Act from her position; (4) order a person to cease and desist from any violation of the Act; and (5) make restitution to borrowers for damages, and any other conditions that the department deems necessary and appropriate. *Id.* § 46:10B-28(7)(d)(1)-(6).

131. When the Act was initially pre-filed for introduction into the 2002 New Jersey legislative session, it contained the language, "[t]he Commissioner of Banking and Insurance shall promulgate regulations pursuant to the 'Administrative Procedure Act,' P.L.1968, c.410 (C.52:14B-1 et seq.) necessary to effectuate the provisions of this act." S. 2187, 2001 Leg., 209th Sess., § 12 (N.J. 2001) (emphasis added). This language clearly granted DOBI a broad mandate to interpret the Act. The final version of the bill, however, was revised to limit the scope of DOBI's interpretive authority to that "necessary to effectuate the provisions of subsections f. and g. of section 5 and section 11 of this act." § 46:10B-35(14).

132. § 46:10B-35(14).

provisions.<sup>133</sup> While such guidelines are not binding, courts should view them as persuasive authority, particularly given DOBI's mandate to protect and educate "consumers and promote[] the growth, financial stability and efficiency of" the banking industry.<sup>134</sup> Where DOBI's guidance is inconsistent with the plain text of the Act, its authority is obviously restricted.

*A. The Act's Scope: Regulating Most Home Loans a Little, but High Cost Home Loans a Lot*

The Act designates three classes of loans – "Home Loans," "Covered Home Loans" and "High Cost Home Loans" – and subjects creditors who issue them, as well as the secondary market investors who purchase them, to increasing levels of regulation.<sup>135</sup> The New Jersey legislature concluded that the Act's prohibitions on practices associated with the extremely broad category of Home Loans, such as financing single premium credit insurance and encouraging borrowers to default, are per se unreasonable in the residential mortgage context and can virtually never be economically justified.<sup>136</sup> The legislature also appears to have recognized that High Cost Home Loans (ones that have either very high rates or points and fees structures) render borrowers increasingly susceptible to default and foreclosure.<sup>137</sup> At the same time, High Cost Home Loans are typically extended to low-income borrowers who are financially unsophisticated, making them particularly vulnerable to the abuses of predatory lenders.<sup>138</sup> Accordingly, the Act bans numerous additional loan terms when made in connection with High Cost Home Loans, such as balloon payments, negative amortizations, and default interest rates, while also mandating clear

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133. BULLETIN NO. 03-15, *supra* note 125, at 1; HOLLY C. BAKKE, N.J. DEP'T OF BANKING AND INS., BULLETIN NO. 03-30 (2003) [hereinafter BULLETIN NO. 03-30], available at [http://www.mbaa.org/state\\_update/2003/nj/bulletin03-30.pdf](http://www.mbaa.org/state_update/2003/nj/bulletin03-30.pdf) (Nov. 18, 2003).

134. N.J. DEP'T OF BANKING AND INS., MISSION STATEMENT, available at <http://www.state.nj.us/dobi/dobimiss.htm> (last visited Feb. 26, 2004). In addition, because the Act grants DOBI powers to investigate and impose penalties for certain violations of the Act, see N.J. STAT. ANN. § 46:10B-28(7)(a)-(c), subprime lenders can rely upon DOBI Bulletins in predicting how DOBI will interpret and enforce provisions of the Act. See BULLETIN NO. 03-30, *supra* note 133, at 7.

135. § 46:10B-24(3).

136. *See id.*

137. *Id.*

138. *See supra* text accompanying notes 51-54.

disclosures and, in certain cases, loan counseling.<sup>139</sup> Undoubtedly reflecting a legislative compromise, the Act bans the particularly dangerous practice of loan flipping for "Covered Home Loans," a category that is slightly broader than High Cost Home Loans.<sup>140</sup>

### 1. Application to Creditors

The Act governs only Home Loans made by "Creditors," defined as those who extend consumer credit that is (i) subject to a finance charge or (ii) payable by five or more installments and to whom the obligation is payable at any time.<sup>141</sup> This definition appears intended to screen out informal lenders, such as family members who do not extend "consumer credit." Notably, the term "Creditor" also includes mortgage brokers, as well as anyone "who directly or indirectly solicits, processes, places or negotiates home loans for others," which ensures that all parties who are involved in arranging financing are subject to its prohibitions and penalties.<sup>142</sup> It also

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139. § 46:10B-26(5)(a)-(g).

140. § 46:10B-26(5).

141. § 46:10B-24(3) ("Creditor"). The term "Creditor" includes federal savings associations and national banks. *See infra* note 146. The federal government, however, has preempted application of HOSA to federal savings and loans and savings banks and appears likely to preempt regulation of national commercial banks as well. Thirty-three percent of all banking institutions operating in New Jersey are nationally or federally chartered and would therefore not fall under HOSA regulation. N.J. DEP'T OF BANKING AND INS., PRIMARY REGULATORS OF BANKING INSTITUTIONS WITH OFFICES IN NEW JERSEY (2003), *available at* <http://www.state.nj.us/dobi/acrobat/primregs.pdf> (June 30, 2003). There is no readily available data as to what percentage of market share such federally chartered entities have in the New Jersey mortgage market. HMDA year 2000 data, however, indicates that of the top 25 participants in New Jersey's home purchase and refinance market (which collectively originate roughly 55% of all New Jersey residential loans), 10 of the banks and mortgage-lending institutions are state-chartered and originate approximately 21.46%, or \$6.754 billion, in residential loans. INSIDE MORTGAGE FIN. PUBL'NS, INC., REGIONAL MORTGAGE MARKET GUIDE 242 (2001).

142. § 46:10B-24(3) ("Creditor"). While including mortgage brokers within the definition of "Creditor," the Act also provides a meaningful limitation for the scope of that liability:

Notwithstanding any provision of this Act to the contrary, a mortgage broker shall be liable under the provisions of this act only for acts performed by the mortgage broker in the course of providing mortgage brokering services. However, a mortgage broker may be held liable for acts performed by the mortgage broker outside the scope of mortgage brokering services if the acts are related to the purchasing or the making of a home loan and are otherwise prohibited under this Act.

*Id.* § 46:10B-33(12).

ensures that those who finance – but do not arrange – Home Loans cannot avoid regulation by assigning various lending tasks, such as solicitation and origination, to different entities.<sup>143</sup> This broad definition of Creditor appears to include home improvement contractors and manufactured home sellers who have substantial involvement in arranging a Home Loan.<sup>144</sup> Significantly, federal regulatory agencies, the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC), have respectively concluded that many of HOSA's prohibitions are preempted as to federal savings associations and national banks, as well as to the operating subsidiaries of both categories of entities.<sup>145</sup>

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Thus, a mortgage broker acting *qua* mortgage broker is only liable for her own violations of the Act and is not jointly and severally liable along with the Creditor for the Creditor's actions. The Act also excludes from the definition of "Creditor" attorneys and title insurers who are unaffiliated with the Creditor. *Id.* § 46:10B-24.

143. See Eggert, *supra* note 9, at 3 (describing how the lending industry structures itself to avoid liability to borrowers).

144. See § 46:10B-24(3) ("Creditor").

145. See OTS Op. Chief Counsel P-2003-5, at 4 (2003) (opining that Federal Home Owners' Loan Act (HOLA), 12 U.S.C. § 1461 (2000), preempts application of HOSA to federal savings associations, their operating subsidiaries and their assignees), available at <http://www.ots.treas.gov/docs/56305.pdf> (July 22, 2003); Press Release, Office of the Comptroller of the Currency, OCC Issues Final Rules on National Bank Preemption and Visitorial Powers; Includes Strong Standard to Keep Predatory Lending out of National Banks (Jan. 7, 2004) (noticing issuance of final rules that revise 12 C.F.R. parts 7 and 34 so as to preempt application of state predatory lending laws to nationally chartered banks and their operating subsidiaries), available at <http://www.occ.treas.gov/scripts/NewsRelease.aspx?Doc=ZN9I8HTT.xml>. But see *Hearing Before the House Comm. on Fin. Servs. Subcomm. on Oversight and Investigations*, 108th Cong. 7 (2003) (testimony of AARP Board of Directors member W. Lee Hammond) (arguing that OCC does not have authority to preempt state predatory lending laws as to operating subsidiaries of national banks). The OCC has taken the position that federal preemption of state predatory lending laws as to nationally chartered banks will not dramatically increase predatory lending in New Jersey as few of those institutions are subprime lenders, let alone predatory lenders. The OCC found that as far as national banks are concerned, "there were 178 lenders whose business focus was subprime mortgage lending in 2001. The majority, or 112 (63%), were independent mortgage companies. Of the remaining lenders, 30 (17%) were non-bank affiliates and only 36 (20%) were depository institutions or their direct subsidiaries." OCC Working Paper, *supra* note 37, at 4. This position is somewhat undercut by the fact that nationally chartered banks have been purchasing subprime lenders and operating them as subsidiaries. See, e.g., *HSBC Holdings PLC: Regulators, Shareholders Clear Household International Deal*, WALL ST. J., Mar. 31, 2003, at B4. This trend will increase the number of preempted institutions that make subprime and predatory loans. Cf. Letter from H. Robert Tillman, Director, N.J. Department of Banking and Insurance, Division of Banking, to James E. Gilleran, Director, Office of Thrift

## 2. Three Tiers of Home Loan Coverage

The Act classifies three types of residential mortgage loans and subjects each to different levels of regulation. First, the Act defines very broadly the category of "Home Loans." Home Loans are extensions of credit to borrowers secured by either: (i) a mortgage or deed of trust on real estate for a one- to six-family dwelling that is or will be occupied by the borrower as her principal dwelling; or (ii) a security interest in a "manufactured home"<sup>146</sup> that is or will be occupied by a borrower as her principal dwelling.<sup>147</sup> Exceeding the scope of protections offered by HOEPA, the Act also covers purchase money mortgages (mortgages for initial home

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Supervision (Aug. 19, 2003) (inquiring as to how many subsidiaries of entities regulated by OTS offer loans in New Jersey), *available at* <http://www.state.nj.us/dobi/PressReleases/otsletter082503.pdf>.

While the National Credit Union Administration (NCUA) has not explicitly held that HOSA is preempted as to federal credit unions, it has promulgated regulations that preempt a broad swath of state lending laws. 12 C.F.R. § 701.21(b) (2003). Moreover, it has issued an opinion letter preempting Georgia's predatory lending law. NCUA Preemption of the Georgia Fair Lending Act, NACU Op. Assoc. Gen. Counsel (Nov. 10, 2003), *available at* [http://www.ncua.gov/ref/opinion\\_letters/2003\\_letters/03-0412.htm](http://www.ncua.gov/ref/opinion_letters/2003_letters/03-0412.htm).

Congress is also considering broadly preempting state predatory lending laws. Representative Robert Ney (R-Ohio) proposed a bill on February 14, 2003, H.R. 833, called the Responsible Lending Act. The Ney bill is designed to preempt state regulation of the lending industry entirely. Ann McDonald, *State Anti-Predatory Lending Laws: More Harm than Help?*, 8 AM. BANKER-BOND BUYER 9, at 40 (2003). In addition to providing one lending standard for creditors, the bill is seen as an attempt to weaken the stronger protections that some states, including New Jersey, have recently enacted in response to the rapid rise in predatory lending. *Consumer Group: Ney's 'Pre-Emption' Bill Goes Too Far*, 27 AM. BANKER-BOND BUYER 10 (2003). The Ney bill, as well as proposed amendments to RESPA, FCRA and laws governing flood insurance and government-sponsored entity regulation, which are set to expire this year, appear to be currently stalled in Congress. STEVE KERCH, CBS MARKETWATCH, *HILL CLIMBING: CONGRESSIONAL STALEMATE OVER KEY REALTY ISSUE* (2003), *available at* <http://cbs.marketwatch.com> (Oct. 24, 2003). Congressional commentators predict little progress in the coming year. *See id.* More than likely, existing legislation will be automatically renewed for a year, so that residential mortgage lending will not become an issue in the 2004 election. *Id.*; *see also* Lew Sichelman, *MBA Sees No Quick Fixes*, 28 NAT'L MORTGAGE NEWS 1 (2003), *available at* 2003 WL 7687729.

146. While not defined in the Act, the category of manufactured homes appears to include modular homes, panelized homes, pre-cut homes, and mobile homes. *See* MANUFACTURED HOUS. INST., *THE DEFINITION OF A MANUFACTURED HOME*, *available at* [http://www.manufacturedhousing.org/lib/showtemp\\_detail.asp?id=74&cat=1](http://www.manufacturedhousing.org/lib/showtemp_detail.asp?id=74&cat=1) (last visited Aug. 29, 2003).

147. N.J. STAT. ANN. § 46:10B-24(3) (West 2003) ("Home Loan").

purchases) and open-end lines of credit.<sup>148</sup> Like HOEPA, the Act excludes “reverse mortgage transactions” from its regulatory scope.<sup>149</sup> The large majority of residential mortgage loans in New Jersey would fall into the Act’s classification of Home Loans. By definition, Home Loans include the more restrictive categories of “Covered Home Loans” and “High Cost Home Loans,” which are described below.

Second, the Act classifies a certain subset of Home Loans as “Covered Home Loans.” Covered Home Loans are defined by reference to a “points and fees” trigger lower than that for High Cost Home Loans (defined below), and therefore cover a greater proportion of high-fee loans. This category comprises Home Loans where the total points and fees payable in connection with the loan exceed: (i) 4% of the total loan amount for loans of more than \$40,000 or (ii) 4.5% of the total loan amount if it is \$40,000 or less or if it is insured by the Fair Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA).<sup>150</sup> Excluded from the definition of points and fees are conventional prepayment penalties or not more than two “Bona Fide Discount Points” (each, a “Bona Fide Discount Point”).<sup>151</sup> The definition of Covered Home Loans contains no cap for the principal amount of such loans.<sup>152</sup> In addition, by definition, Covered Home Loans include all High Cost Home Loans.<sup>153</sup>

Finally, “High Cost Home Loans” are the narrowest and most heavily regulated subset of loans. High Cost Home Loans require a principal amount

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148. Open-end credit plans represent a credit extension where the exact amount of money lent or advanced at any given time is not fixed. *See* 15 U.S.C. § 1602(i). Because open-end home equity lines of credit have been increasingly utilized by borrowers, including subprime borrowers, HOSA’s express regulation of such loans is a significant increase of scope over that of HOEPA. *See supra* note 116 and accompanying text.

149. Reverse mortgage transactions are mortgages that reverse the direction of payments. They are typically used by older homeowners, who can borrow against the substantial equity in their homes to receive periodic cash payments. Repayment of the loan amount is not required until the borrower transfers the dwelling, ceases to occupy it as a primary residence or dies. *See id.* § 1602(bb).

150. N.J. STAT. ANN. § 46:10B-24 (“Covered Home Loan”) (West 2003).

151. *Id.* For example (excluding up to two Bona Fide Discount Points) a \$100,000 Home Loan would be a Covered Home Loan if its points and fees were more than \$4000; a \$10,000 Home Loan would be a Covered Home Loan if its points and fees were more than \$450; and a \$100,000 VA or FHA Home Loan would be a Covered Home Loan if its points and fees were more than \$4500.

152. *Id.*

153. *Id.*



of less than \$350,000 (such amount to be adjusted annually)<sup>154</sup> and, like a HOEPA-covered loan, an interest rate or points and fees that exceed a specified threshold.<sup>155</sup> The interest rate threshold under HOSA is defined by incorporating the APR triggers set by HOEPA and the Federal Reserve Board's Regulation Z.<sup>156</sup> Thus, HOSA's interest rate trigger, like HOEPA's, is 8% above the prevailing interest rate on a Treasury security of a comparable maturity for first lien mortgages, and 10% above the prevailing Treasury security rate for a second lien mortgage.<sup>157</sup> At the time HOSA was enacted (May 1, 2003), a 20-year fixed interest Treasury security (the relevant comparable security for a 30-year mortgage) carried an interest rate of 4.93%.<sup>158</sup> Accordingly, under both HOEPA and HOSA, only those loans with an APR of 12.93% or higher would be classified and regulated as High

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154. *Id.* The \$350,000 threshold will be adjusted each year to include the last published increase of the housing component of the national Consumer Price Index, New York-Northeastern New Jersey Region. By way of example, that component increased four percent from July 2002 to July 2003. U.S. DEP'T OF LABOR, NEW YORK-NORTHERN NEW JERSEY CPI UP 0.4 PERCENT IN JULY; 3.0 PERCENT INCREASE FROM YEAR AGO (2003), available at <http://www.bls.gov/ro2/cpinynj.htm> (last modified Dec. 16, 2003).

155. § 46:10B-24(3).

156. *Id.* ("threshold" (1)); see also 15 U.S.C. § 1602(aa) (2000); 12 C.F.R. § 262.32 (2003). This determination is made without regard to whether the loan transaction is or may be a "residential mortgage transaction." N.J. STAT. ANN. § 46:10B-24(3) (West 2003) ("threshold"(1)); see also 12 C.F.R. § 226.2(a)(24) (defining a "residential mortgage transaction"). A residential mortgage transaction is a loan to finance the acquisition or initial construction of a principal dwelling. *Id.* While such types of loans do not fall within the ambit of HOEPA, they do fall within that of HOSA. Thus, HOSA, unlike HOEPA, applies to purchase money and construction mortgages for primary dwellings.

157. See 15 U.S.C. § 1602(aa)(1); 12 C.F.R. § 226.32(a)(1)(i). HOEPA's APR trigger had been lowered by the Federal Reserve Board in 2001 (with compliance mandatory by October 1, 2002), from a threshold of 10% (for both first and second lien loans) above comparable Treasury securities. 66 Fed. Reg. 65,606, 65,608-610 (Dec. 20, 2001).

158. FED. RESERVE BD., FEDERAL RESERVE STATISTICAL RELEASE H.15 SELECTED INTEREST RATES (2003), available at <http://www.federalreserve.gov/Releases/H15/20030421> (Apr. 21, 2003) [hereinafter APRIL RATES]. The HOEPA and HOSA trigger for a first-lien mortgage is eight points above "the yield on Treasury securities having comparable periods of maturity to the loan maturity as of the fifteenth day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor." 12 C.F.R. § 226.32(a)(1)(i). Because the federal government has recently stopped issuing 30-year Treasuries, the Federal Reserve Board staff has interpreted the Regulation Z trigger language to mean that lenders should use the yield for 20-year constant maturities in place of the yield for 30-year maturities. *Id.* §§ 226.32(a)(1)(i), 226.32(a)(1)(i)-(4)(iii). These yields may be determined from the Board's "Selected Interest Rates" (statistical release H-15). *Id.* § 226.32(a)(1)(i)-(4).

Cost Home Loans.<sup>159</sup> Indeed, the High Cost Home Loan APR threshold averages approximately a full seven percentage points above the national average interest rate of 5.7% for a fixed rate, 30-year home loan measured at the time of HOSA's passage.<sup>160</sup> HOSA's APR trigger, therefore, covers a narrow category of very expensive loans.

HOSA also contains a "total points and fees threshold" which triggers designation as a High Cost Home Loan.<sup>161</sup> While HOEPA's points and fees threshold is set fairly high at 8% of the total loan value, HOSA's points and fees threshold is uniformly lower than HOEPA's.<sup>162</sup> It employs a sliding scale, allowing Creditors to charge higher points and fees – and avoid a loan's "high cost" designation – for loans that have lower values. Under the Act, the points and fees trigger is met where the borrower is charged, at loan closing: (i) for total loan amounts of \$40,000 or greater, 5% or more of the total loan amount; (ii) for total loan amounts of \$20,000 to \$39,999, 6% of the total loan amount; and (iii) for total loan amounts of \$1 to \$19,999, the lesser of \$1000 or 6%.<sup>163</sup> The Act specifically excludes from the calculation of points and fees a "conventional prepayment penalty"<sup>164</sup> and up to two Bona Fide Discount Points, as explained in detail below.

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159. As the yield for 20-year constant maturities on April 15, 2003, was 4.93%, APRIL RATES, *supra* note 158, the precise HOEPA rate trigger for a 30-year fixed interest loan for which the creditor received the application on May 1, 2003 (the day the Act was signed) was 12.93%. 12 C.F.R. § 226.32(a)(1)(i).

160. See FREDDIE MAC, 2003 WEEKLY MORTGAGE RATES RELEASES (2003), available at <http://www.freddiemac.com/pmms/pmms2003sum.htm> (Sept. 4, 2003). The points and fees national average for loans during that period was 0.6%. *Id.*

161. N.J. STAT. ANN. § 46:10B-24 (West 2003) ("total points and fees threshold").

162. 15 U.S.C. § 1602(aa)(3).

163. N.J. STAT. ANN. § 46:10B-24 (West 2003) ("total points and fees threshold"). For example (excluding up to two Bona Fide Discount Points) a \$100,000 Home Loan would be a High Cost Home Loan if its points and fees were \$5000 or more; a \$30,000 Home Loan would be a High Cost Home Loan if its points and fees were \$1800 or more; and a \$18,000 Home Loan would be a High Cost Home Loan if its points and fees were \$1000 (that is, the lesser of \$1000 or 6% of the loan amount).

164. *Id.* § 46:10B-24 ("conventional prepayment penalty").

[A "conventional prepayment penalty" is] any prepayment penalty or fee that may be collected or charged in a home loan, and that is authorized by law other than by this act, provided the home loan (1) does not have an annual percentage rate that exceeds the conventional mortgage rate by more than two percentage points; and (2) does not permit any prepayment fees or penalties that exceed two percent of the amount prepaid.

*Id.*

### 3. Calculation of the Total Points and Fees Threshold

The Federal TILA specifically mandates the disclosure of a loan's APR – a standardized form of interest rate calculation – to encourage loan price transparency and thereby provides consumers with a clearer understanding of the cost of a loan.<sup>165</sup> The imposition of high points and fees, which appear almost invariably with subprime and all predatory loans, are far more confusing. Indeed, one of the persistent abuses in the home loan market has been lenders' efforts to add charges to a loan that federal law does not include in the loan's APR.<sup>166</sup> HOEPA and now HOSA attempt to set forth a comprehensive list of charges that must be included in calculating a loan's points and fees, and therefore, possibly triggering classification as a Covered Home Loan or a High Cost Home Loan. However, by including several items in the catalogue of charges that are specifically excluded from the HOEPA points and fees threshold calculation, HOSA will shift a greater proportion of Home Loans into its heavily regulated categories. While HOSA's exclusion of up to two Bona Fide Discount Points from the points and fees calculation appears to provide additional flexibility for Creditors, the provision will not significantly affect the classification of High Cost Home Loans for reasons discussed below.<sup>167</sup>

#### a. Calculation of Points and Fees

Under the Act, the following charges must be included in calculating a loan's total points and fees threshold: (1) all items, other than interest and a time price differential, listed in § 1605(a)(1)-(4) of TILA, which includes all points, origination fees, service charges and other charges by the lender such as a loan fee, finder's fee or investigation or credit report fee;<sup>168</sup> (2) all

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165. 15 U.S.C. § 1601(a) (TILA's purpose is to "assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit"); *see also* *Rossman v. Fleet Bank (R.I.) Nat'l Ass'n*, 280 F.3d 384, 389 (3d Cir. 2002); *Schnall v. Amboy Nat'l Bank*, 279 F.3d 205, 219 (3d Cir. 2002); *TRUTH IN LENDING*, *supra* note 79, at 31 (TILA is "Congress's effort to guarantee the accurate and meaningful disclosure of the costs of consumer credit and thereby to enable consumers to make informed choices in the credit marketplace").

166. NAT'L CONSUMER LAW CTR., *TRUTH IN LENDING* 209 (4th ed. Supp. 2002).

167. *See infra* text accompanying note 185.

168. N.J. STAT. ANN. § 46:10B-24(3)(1) (West 2003). Section 1605(a) of TILA lists items that must be included in HOEPA's points and fees calculation. 15 U.S.C. § 1605(a). HOSA incorporates into its definition of points and fees, the following items (excluding interest and the time price differential): "any amount payable under a point, discount, or other

closing-related costs specifically listed in § 1605(e) of TILA;<sup>169</sup> (3) “all compensation paid directly or indirectly to a mortgage broker;”<sup>170</sup> (4) “the cost of all premiums financed by the creditor, directly or indirectly,” for any credit insurance;<sup>171</sup> (5) the maximum loan prepayment fees and penalties that could be charged in connection with the loan and all prepayment fees or penalties that are actually incurred by a borrower if the loan refinances a previous loan held by the same Creditor or its affiliate.<sup>172</sup>

For the purposes of the Act, the term “points and fees” does *not* include the following: (1) title insurance premiums and fees;<sup>173</sup> (2) taxes, filing fees, and recording and other charges paid to public officials for perfecting or satisfying a security interest; (3) certain “reasonable” fees paid to persons

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system or additional charges; service or carrying charge; loan fee, finders fee, or similar charge; and fee for an investigation or credit report.” *Id.* § 1605(a)(1).

169. N.J. STAT. ANN. § 46:10B-24(3)(2) (West 2003). Under § 1605(e) of TILA, these charges are actually *excluded* from HOEPA’s points and fees calculation. Section 1605(e) reads as follows:

The following items, when charged in connection with any extension of credit secured by an interest in real property, shall not be included in the computation of the finance charge with respect to that transaction:

- (1) Fees or premiums for title examination, title insurance, or similar purposes.
- (2) Fees for preparation of loan-related documents.
- (3) Escrows for future payments of taxes and insurance.
- (4) Fees for notarizing deeds and other documents.
- (5) Appraisal fees, including fees related to any pest infestation or flood hazard inspections conducted prior to closing.
- (6) Credit reports.

15 U.S.C. § 1605(e).

HOSA treats the items listed in § 1605(e) in the opposite manner of TILA by *including* them in its points and fees calculation. Section 1605(e), like § 1605(a) references “credit reports,” making HOSA redundant in this small way.

170. N.J. STAT. ANN. § 46:10B-24(3)(3) (West 2003). This provision would force Creditors to reflect as a real cost to borrowers the indirect compensation paid to brokers by Creditors in the form of a yield spread premium. *See* HUD-Treasury Report, *supra* note 8; *see also* 15 U.S.C. § 1602(aa)(4)(B) (requiring that “all compensation paid to mortgage brokers” be included in the total points and fees calculation).

171. N.J. STAT. ANN. § 46:10B-24 (West 2003).

172. *Id.* § 46:10B-24(5), (6). As discussed below, unlike other state predatory lending legislation and HOEPA itself, HOSA does not place any express limitation on the imposition of prepayment penalties on High Cost Home Loans. *See infra* Part III.B.4.

173. *Id.* § 46:10B-24 (“points and fees” (2)). As described below, this exclusion appears to contradict the inclusion of title insurance premiums in the points and fees calculation required elsewhere in the Act. *Id.*

unaffiliated<sup>174</sup> with either the Creditor or the mortgage broker,<sup>175</sup> for tax payment services, flood certification, pest, flood, appraisal and inspection fees, attorney's or notary's fees, escrow charges,<sup>176</sup> and fire and flood insurance premiums, provided that such premiums are purchased from an entity that is not affiliated with the Creditor or certain disclosures are made.<sup>177</sup>

Notably, HOSA's definition of "points and fees" is, in certain contexts, either moot, inconsistent or confusing. First, the Act's inclusion of financed premium insurance is rendered moot by section 10B-25(4)(a) of the Act, which categorically prohibits the inclusion of financed premium insurance in the first place in *any* Home Loan.<sup>178</sup> No Creditor will ever calculate the cost of such insurance because no Creditor will be permitted to even charge for such a product. Perhaps the New Jersey legislature meant to prohibit the charging of only *single premium* credit insurance in connection with Home Loans, while requiring the inclusion in the points and fees calculation, the

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174. "Affiliate" is defined by the Act with reference to the definition set forth in 12 U.S.C. § 1841. N.J. STAT. ANN. § 46:10B-24(3) (West 2003) ("affiliate"); *see also* 12 U.S.C. § 1841(k) (2000) (defining an affiliate as "any company that controls, is controlled by, or is under common control with another company").

175. These exclusions from "points and fees" incorporate "the conditions" in 12 C.F.R. § 226.4(c)(7), which are actually listed in § 226.32(b)(1)(iii).

176. *See infra* text accompanying note 182 (regarding the Act's ambiguous treatment of escrows).

177. These conditions relating to premiums have been incorporated from 12 C.F.R. § 226.4(d)(2). N.J. STAT. ANN. § 46:10B-24 (West 2003) ("points and fees"). Section 226.4(d)(2) states:

(i) insurance coverage may be obtained from a person of the consumer's choice, and this fact is disclosed. (ii) If the coverage is obtained from or through the creditor, the premium for the initial term of insurance coverage shall be disclosed. If the term of insurance is less than the term of the transaction, the term of insurance shall also be disclosed.

12 C.F.R. § 226.4(d)(2).

DOBI has taken the position that "mortgage insurance" and "private mortgage insurance" premiums are not considered in calculating the "points and fees" trigger. BULLETIN NO. 03-30, *supra* note 133, at 8. This seems to be the correct reading of the Act for, among other reasons, the Act's enumeration of "points and fees" does not include such premiums. *See id.* (outlining this and other reasons why such premiums are not to be considered when calculating the "points and fees" trigger).

178. *Compare* N.J. STAT. ANN. § 46:10B-24(4) (West 2003) (requiring inclusion in points and fees calculation "[t]he cost of all premiums financed by the creditor, directly or indirectly for any credit life, credit disability, credit unemployment or credit property insurance, or any life or health insurance"), *with id.* § 46:10B-25(4)(a) (prohibiting charging any such fees in connection with a Home Loan).

broader category of all financed credit insurance. In any event, it appears that the legislature may have relied too reflexively on the points and fees calculations set forth in HOEPA, which require that charges for single premium credit insurance be calculated as part of the HOEPA points and fees trigger,<sup>179</sup> but which do not otherwise prohibit the imposition of such insurance charges.

Second, in its incorporation by reference of portions of HOEPA, the Act creates an apparent inconsistency as to whether title insurance fees are included in the points and fees calculation. On the one hand, “points and fees” include, by reference to § 1605(e)(1) of TILA, “[f]ees or premiums for title examination, title insurance, or similar purposes.”<sup>180</sup> On the other hand, the Act expressly excludes from the definition of “points and fees” any “title insurance premiums and fees, charges and premiums paid to a person or entity holding an individual or organization insurance producer license in the line of title insurance or a title insurance company, as defined by” New Jersey’s title insurance licensing law.<sup>181</sup> Perhaps the best way to harmonize this apparent inconsistency is to read the former provision in this portion of the Act as broader than and inclusive of the latter; that is, the former category covers title fees paid to all parties, while the latter category covers title fees paid only to licensed title insurers. Thus, by subtracting the smaller from the broader category, what remains and must be included in the definition of “points and fees” is title fees paid to unlicensed title service providers. For instance, traditional title insurance premiums, paid to a third-party provider, would be excluded from the definition, while any fees collected by a Creditor in connection with title issues – such as some kind of referral fee – would be included.

Finally, the Act creates some confusion about whether or in what form escrow charges should be included in the calculation of points and fees. On the one hand, the Act includes escrows for future payments of taxes and insurance. On the other hand, the same subsection of the Act excludes bona fide and reasonable escrow charges paid to a person other than a Creditor or its affiliate or to the mortgage broker or its affiliate. Textually, these two sections seem to mean that escrows for future payments of taxes and insurance that are either paid to the Creditor, mortgage broker, or one of their affiliates or that are neither bona fide nor reasonable, are included in the definition of points and fees.

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179. See 12 C.F.R. § 226.32(b)(iv).

180. 15 U.S.C. § 1605(e)(1) (2000).

181. N.J. STAT. ANN. § 46:10B-24 (West 2003) (“points and fees”).

Although this appears to be the most coherent reading of the text, it is inconsistent with standard lending practices in the prime market in which the retention of reasonable escrows is common.<sup>182</sup> It would seem more consistent with the Act's purposes if only those escrow charges that were in excess of reasonable escrowed taxes and fees and insurance premiums were included within the definition of points and fees. Notwithstanding this, the inclusion of a reasonable escrow should only make up a very small portion of the points and fees calculation (because lenders often escrow only a few months of payments at anyone time) and so, perhaps, its inclusion may have been purposeful.

#### b. Exceptions for Bona Fide Discount Points

In the conventional loan market, lenders frequently charge points in exchange for a lower loan interest rate than the borrower would otherwise receive. Such discount points most benefit borrowers who can recoup their initial point investment by paying the bargained-for lower interest rate over a long period of time. The Act recognizes the value of such an exchange by excluding from both the Covered Home Loan threshold and the High Cost Home Loan points and fees threshold, up to two Bona Fide Discount Points. According to the Act, in order for discount points to be "bona fide," they must meet two criteria: (i) the interest rate on the loan that is being discounted, prior to the application to the discount points, must be at most two points above the conventional mortgage rate<sup>183</sup> for first lien mortgages (and at most three-and-a-half points for junior lien mortgages); and (ii) they must be knowingly paid by the borrower for the express purpose of, and in fact, reducing the loan's interest rate, so that the borrower recovers an amount equal to such discount points within the first five years of the scheduled loan payments.<sup>184</sup>

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182. Indeed, the New Jersey Department of Banking has taken the position that such escrows are not included within the ambit of "points and fees." BULLETIN NO. 03-15, *supra* note 125, at 7.

183. Generally considered the average national mortgage rate, it is specifically defined by the Act as "the most recently published annual yield on conventional mortgages published by" the Federal Reserve Board. N.J. STAT. ANN. § 46:10B-24(3) (West 2003) ("conventional mortgage rate"). For example, at around the time of the Act's passage, the conventional mortgage rate was 4.93%. *See supra* text accompanying notes 157-60.

184. *Id.* § 46:10B-24(4) ("bona fide discount points"). The Act considers discount points to be recouped within the first five years if:

the reduction in the interest rate that is achieved by the payment of the loan discount points reduces the interest charged on the scheduled payments such that the

Because High Cost Home Loans frequently have interest rates that far exceed two points above the conventional mortgage rate, the Bona Fide Discount Point exclusion will have a relatively insubstantial effect on that category of loans. The exclusion may apply to the rare case of a Home Loan that is classified as high cost solely by virtue of its high points and fees structure, but that otherwise has an interest rate that is within two points of the conventional mortgage rate.<sup>185</sup> The Bona Fide Discount Point provision will certainly have a greater impact on the Covered Home Loan category because it will prevent some Home Loans from being classified as Covered Home Loans.

### *B. The Prohibitions Under the Act*

As described above, the Act provides for the greatest amount of regulation for High Cost Home Loans based upon the valid assumption that those loans are the most likely to involve predatory practices. The Act also prohibits loan flipping for Covered Home Loans (and the included category of High Cost Home Loans) and certain additional practice for all Home Loans, which are considered economically unjustifiable.

#### **1. High Cost Home Loans**

While loan terms that are prohibited by the Act may have legitimate economic justification when employed in commercial or prime residential credit markets, the legislature appears to have taken the position that such terms are overwhelmingly predatory in the High Cost Home Loan market. The legislature has also seen fit to add additional disclosure responsibilities in this arena.

##### **a. Balloon Payments**

The Act prohibits balloon payments in connection with High Cost Home Loans. Typically, a balloon payment appears as a very large lump-sum payment that is due at the end of the term of a loan that has a schedule of

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borrower's dollar amount of savings in interest over the first five years is equal to or exceeds the dollar amount of loan discount points paid by the borrower.

*Id.*

Note, however, that this does not necessarily amount to an actual savings by the borrower because it fails to account for the time value of money.

185. It will certainly not be surprising, however, to see the subprime market develop low-interest, high-fee mortgage products as they adapt to the requirements of the Act.



periodic payments.<sup>186</sup> The Act defines a balloon payment more expansively as any "scheduled payment that is more than twice as large as the average of earlier scheduled payments."<sup>187</sup> Lenders claim balloon payments allow borrowers to obtain loans at lower monthly costs in anticipation of increased income or future refinancing at lower rates.<sup>188</sup> If the income increase does not occur and/or interest rates do not drop, however, the borrower owes an enormous final payment that she often cannot pay. In any event, the legislature seems to have concluded that most balloon payments for subprime borrowers are predatory because it would be unlikely that such a borrower could make the balloon payment and may thereby be forced to refinance with the same Creditor on disadvantageous terms.

#### b. Negative Amortization

The Act prohibits High Cost Home Loans in which "the outstanding principal balance will increase at any time over the course of the loan because the regular periodic payments do not cover the full amount of interest due."<sup>189</sup> Such a prohibition obviously bars those loans that are intended from the outset to be negative amortization loans. But it also bars adjustable rate loans with capped monthly payments, even where rising interest rates would require higher monthly payments to ensure that the principal balance of the loan did not increase over time. As with balloon loans, lenders claim that negative amortization loans allow borrowers to obtain loans at lower monthly costs in anticipation of increased income or future refinancing at lower rates.<sup>190</sup> Again, the legislature seems to have taken the position that virtually all negative amortization loans are predatory in the High Cost Home Loan arena.

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186. See *supra* Part II.C.6.

187. § 46:10B-26(a). This provision does not apply "when the payment schedule is adjusted to the seasonal or irregular income of the borrower." *Id.*

188. See FANNIE MAE, TAKING THE MYSTERY OUT OF YOUR MORTGAGE: WHAT DESKTOP UNDERWRITER ANALYZES IN YOUR LOAN APPLICATION 25 (2003).

189. § 46:10B-26(b).

190. FAIR HOUS. ADMIN., FHA INSURED LOANS: CALCULATING GRADUATED PAYMENT MORTGAGES, available at [http://www.hud.gov/offices/hsg/sfh/gpm/gpm\\_calc.cfm](http://www.hud.gov/offices/hsg/sfh/gpm/gpm_calc.cfm) (last updated Nov. 27, 2001).

### c. Default Interest Rates

The Act bars the inclusion of provisions in High Cost Home Loans that allow the Creditor to increase the interest rate on the loan after a borrower's default.<sup>191</sup> Lenders argue that such default interest rates encourage timely payment as the threat of higher interest rates will encourage borrowers to make their payments. The legislature appears to have agreed with consumer advocates who have argued that such provisions make it difficult to cure a default once it has occurred and thus unnecessarily increase the risk of default and, ultimately, foreclosure.<sup>192</sup>

### d. Prepaid Finance Charges

Prepaid finance charges generally refer to "any finance charge paid separately in cash or by check before or at consummation of a transaction, or withheld from the proceeds of the credit at any time."<sup>193</sup> Prepayment provisions in the prime market are commonly employed to collect the interest due for the days from closing to the first scheduled monthly payment, which typically would not exceed the first 30 days' interest due on the loan.<sup>194</sup> The Act limits prepaid interest provisions in High Cost Home Loans by prohibiting Creditors from retaining at closing any more than two periodic payments – for example, two months' payments on a loan that is repaid on a monthly basis – from the borrower's loan proceeds.<sup>195</sup>

### e. Access to Legal Remedies

The Act voids any provision in a High Cost Home Loan that either: (i) allows a party (such as the Creditor) to "require a borrower to assert any claim or defense in a forum that is less convenient, more costly, or more dilatory for the resolution of a dispute" than the New Jersey courts or (ii) "limits in any way any claim or defense the borrower may have."<sup>196</sup>

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191. § 46:10B-26(c). This provision does not "apply to interest rate changes in a variable rate loan otherwise consistent with the provisions of the loan documents, provided the change in the interest rate is not triggered by the event of default or the acceleration of the indebtedness." *Id.*

192. See NAT'L CONSUMER LAW CTR., *supra* note 166, § 10.4.3.

193. 12 C.F.R. § 226.2(a)(23) (2003).

194. MORTGAGE CALCULATOR FIN. CTR., MORTGAGE TERMS DICTIONARY, available at <http://mortgage-calculators.org/dictionary/dictionary.php3?lit=p> (last visited Jan. 16, 2004).

195. See N.J. STAT. ANN. § 46:10B-26(d) (West 2003).

196. *Id.* § 46:10B-26(e).

Moreover, a Creditor making a High Cost Home Loan must use New Jersey foreclosure procedures.<sup>197</sup>

f. Mandatory Notice to Borrower

In addition to restrictions on Creditor activities, the Act attempts to increase consumer understanding of the lending process. The Act requires that Creditors making High Cost Home Loans provide a notice to the borrower, at least three days prior to the loan closing,<sup>198</sup> which, among other things, encourages the borrower to consult an attorney and “shop around” for the best deal on her loan.<sup>199</sup> In addition, the notice must warn the

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197. *Id.* § 46:10B-26(k). It is unclear whether the legislative intent of this section is to bar mandatory arbitration clauses. Other state predatory lending legislation does bar such clauses, *see, e.g.*, N.C. GEN. STAT. § 24-1.1(e) (2003), but it is not clear whether arbitration would be considered “less convenient, more costly, or more dilatory” than the civil court system. § 46:10B-26(e).

198. N.J. STAT. ANN. § 46:10B-26(f) (West 2003). The Act incorporates the disclosure timing requirements of HOEPA contained in 12 C.F.R. § 226.31(c).

199. N.J. STAT. ANN. § 46:10B-26(f) (West 2003). The Act requires that the text of the notice be substantially in the following form:

**NOTICE TO BORROWER**

YOU SHOULD BE AWARE THAT YOU MIGHT BE ABLE TO OBTAIN A LOAN AT A LOWER COST. YOU SHOULD SHOP AROUND AND COMPARE LOAN RATES AND FEES. MORTGAGE LOAN RATES AND CLOSING COSTS AND FEES VARY BASED ON MANY FACTORS, INCLUDING YOUR PARTICULAR CREDIT AND FINANCIAL CIRCUMSTANCES, YOUR EMPLOYMENT HISTORY, THE LOAN-TO-VALUE REQUESTED AND THE TYPE OF PROPERTY THAT WILL SECURE YOUR LOAN. THE LOAN RATE AND FEES COULD ALSO VARY BASED ON WHICH CREDITOR OR BROKER YOU SELECT.

IF YOU ACCEPT THE TERMS OF THIS LOAN, THE CREDITOR WILL HAVE A MORTGAGE LIEN ON YOUR HOME. YOU COULD LOSE YOUR HOME AND ANY MONEY YOU PUT INTO IT IF YOU DO NOT MEET YOUR PAYMENT OBLIGATIONS UNDER THE LOAN.

YOU SHOULD CONSULT AN ATTORNEY-AT-LAW AND A QUALIFIED INDEPENDENT CREDIT COUNSELOR OR OTHER EXPERIENCED FINANCIAL ADVISOR REGARDING THE RATE, FEES AND PROVISIONS OF THIS MORTGAGE LOAN BEFORE YOU PROCEED. A LIST OF QUALIFIED COUNSELORS IS AVAILABLE BY CONTACTING THE NEW JERSEY DEPARTMENT OF BANKING AND INSURANCE.

YOU ARE NOT REQUIRED TO COMPLETE THIS LOAN AGREEMENT MERELY BECAUSE YOU HAVE RECEIVED THIS DISCLOSURE OR HAVE SIGNED A LOAN APPLICATION.

borrower that (i) by accepting the loan, the Creditor will have a mortgage on her home and (ii) failure to make timely payments can lead to the loss of the borrower's home.<sup>200</sup> HOSA's required disclosures are an important supplement to current federal home mortgagor protections because the disclosures are more comprehensible and comprehensive than those required by TILA and they are coupled, unlike in TILA, with actual prohibitions on predatory behavior.

g. Mandatory Loan Counseling

Recognizing that many High Cost Home Loan borrowers are financially unsophisticated and unfamiliar with fundamental aspects of the consumer credit market, the Act attempts to channel prospective High Cost Home Loan borrowers who finance points and fees<sup>201</sup> to independent non-profit loan counselors.<sup>202</sup> Prior to consummating such a High Cost Home Loan, the Creditor must obtain a certification that the borrower has received such counseling as to the advisability of the transaction.<sup>203</sup> New Jersey currently has a number of established not-for-profits, such as Citizen Action, which provide such loan counseling.<sup>204</sup>

By limiting required loan counseling to those whose High Cost Home Loans have financed points and fees – not simply a very high APR – the legislature appears to offer the benefits of counseling only to those borrowers whose loans contain costs that are less transparent to borrowers. Other High Cost Home Loan borrowers, however, would appear to also

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REMEMBER, PROPERTY TAXES AND HOMEOWNER'S INSURANCE ARE YOUR RESPONSIBILITY. NOT ALL CREDITORS PROVIDE ESCROW SERVICES FOR THESE PAYMENTS. YOU SHOULD ASK YOUR CREDITOR ABOUT THESE SERVICES.

ALSO, YOUR PAYMENTS ON EXISTING DEBTS CONTRIBUTE TO YOUR CREDIT RATINGS. YOU SHOULD NOT ACCEPT ANY ADVICE TO IGNORE YOUR REGULAR PAYMENTS TO YOUR EXISTING CREDITORS.

*Id.*

200. *Id.*

201. Note that a High Cost Home Loan can finance at most two points. § 46:10B-26(l).

202. § 46:10B-26(g). Such counseling must be given by a "third-party nonprofit credit counselor, approved by the United States Department of Housing and Urban Development and the Department of Banking and Insurance" regarding the "advisability of the loan transaction." *Id.*

203. *Id.*

204. See, e.g., N.J. CITIZEN ACTION, WELCOME TO N.J.C.A., available at <http://www.njcitizenaction.org/> (last visited Jan. 16, 2004).

benefit from loan counseling, such as borrowers who are eligible for prime loans but who are about to enter into a High Cost Home Loan due to a lack of information about the consumer credit market.

#### h. Direct Payment to Home Improvement Contractors

Home improvement contractors frequently help generate predatory loans. In many cases, an unscrupulous contractor will arrange financing for a home improvement loan with a pre-selected predatory lender, so as to be paid directly by the complicit lender at loan closing before the work is complete or capably done.<sup>205</sup> Such a direct payment arrangement deprives a borrower of any leverage to control the quality or timeliness of a contractor's work. In response to this prevalent practice, the Act prohibits any of the proceeds from a High Cost Home Loan from being paid directly to a home improvement contractor.<sup>206</sup>

#### i. Loan Modification and Deferral Fees

The Act bars a Creditor from charging a borrower any fees to modify, renew, extend, or amend a High Cost Home Loan or to defer any payment due under the terms of a High Cost Home Loan.<sup>207</sup> This provision, while facially similar to provisions limiting the costs of refinancing, appears to address changes to the non-monetary terms of a loan as well as unplanned contingencies that affect a borrower's ability to make scheduled loan payments.<sup>208</sup> For instance, if a Creditor and borrower agree to any change in the terms of the High Cost Home Loan – as where a borrower wants to defer a few monthly payments during a period of unemployment – the Creditor

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205. See *supra* text accompanying notes 84-85.

206. § 46:10B-26(h). The proceeds of a home-improvement loan must be payable: (i) to the borrower, (ii) jointly to the borrower and the contractor, or (iii) at the election of the borrower, to a third-party escrow agent in accordance with a written agreement signed by the borrower, Creditor and contractor prior to disbursement. *Id.*

207. *Id.* § 46:10B-26(i).

208. Renewing a loan is borrowing a similar amount under the same terms as the previous loan after its payment term has expired. Refinancing is “[p]aying off an existing loan with the proceeds from a new loan, usually of the same size, and using the same property as collateral.” INVESTORWORDS.COM, REFINANCING, available at <http://www.investorwords.com/4115/refinancing.html> (last visited Feb. 26, 2004). Typically, borrowers refinance when they want “to reduce monthly payments or to modify interest charges.” *Id.*

simply cannot charge any fees.<sup>209</sup> It is unclear why the legislature chose to categorically prohibit charges for such modifications – which would appear to dramatically reduce Creditor incentive to agree to loan modifications – when some could be useful to a borrower if made available on reasonable terms.<sup>210</sup>

j. Same-Creditor Refinancings

The Act prohibits any Creditor from flipping Covered Home Loans (which include all High Cost Home Loans) extended by that or any other Creditor in certain circumstances.<sup>211</sup> In addition, section 5(j) of the Act bars a Creditor from charging points and fees for a new High Cost Home Loan that refinances an existing High Cost Home Loan already owned by that same Creditor.<sup>212</sup> This additional prohibition seems to acknowledge that a Creditor refinancing a loan that it already owns faces lower underwriting costs than a new Creditor because it already has at least some underwriting data on and a payment history with that borrower.<sup>213</sup>

k. Limited Financings of Points and Fees

The Act provides that under no circumstances may a Creditor finance, directly or indirectly, points and fees for a High Cost Home Loan that are in excess of 2% of the total loan amount.<sup>214</sup> This provision, of course, does not bar the charging of more than two points if paid in cash, but recognizes that the financing of points and fees represents a hidden cost to many subprime borrowers and frequently has the effect of stripping equity from their homes.<sup>215</sup> This two point cap does allow cash-poor borrowers (e.g., those

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209. This prohibition does not prevent the Creditor from capitalizing deferred interest. Thus, if a borrower missed a payment, the Creditor could add the missed interest to the principal balance due on the loan.

210. Cf. § 46:10B-26(l) (limiting refinancing points and fees for High Cost Home Loans to 2%).

211. See *infra* Part III.B.2.

212. § 46:10B-26(j).

213. Where the originating Creditor still holds the note, this assumption would seem to be particularly valid as it could rely in part on its initial underwriting analysis. This assumption might be weaker where the borrower seeks the refinancing from a Creditor who purchased the loan on the secondary market. Nonetheless, this provision applies to the secondary market purchaser as much as it does to the originator.

214. § 46:10B-26(l).

215. See *supra* text accompanying notes 45-46.

who do not have the cash to pay points and fees up front) to access the equity in their homes, but limits those points and fees to an amount that is more in line with those found in the prime market than with those in the high end of the subprime market.<sup>216</sup>

## 2. Covered Home Loans

As described, the Act's intermediate classification of loans, Covered Home Loans, has a lower points and fees trigger than the High Cost Home Loan classification and includes a greater number of Home Loans within its regulatory scope.<sup>217</sup> Covered Home Loans (which include all High Cost Home Loans) have only one prohibition in addition to those that apply to all Home Loans. This prohibition relates to the practice of "flipping" loans.<sup>218</sup> Flipping refers to creditors' attempts to repeatedly refinance loans, primarily as a way of extracting prepayment penalties, points and other costs.<sup>219</sup> By prohibiting flipping in connection with Covered Home Loans, the legislature appears to have concluded that flipping is a particularly abusive practice that inequitably strips equity from borrowers throughout a greater portion of the subprime market than just the High Cost Home Loan portion.

According to the Act, flipping occurs when: (i) a Creditor makes a Covered Home Loan to a borrower; (ii) that refinances any existing Home Loan<sup>220</sup> that was consummated within the prior 60 months; and (iii) that new loan does not have a "reasonable, tangible net benefit to the borrower."<sup>221</sup> The only elaboration offered by the Act to assess whether a loan provides such a benefit is to consider "all the circumstances, including the terms of both the new and refinanced loans, the economic and noneconomic circumstances."<sup>222</sup> In response to industry concerns about the ambiguity of the "reasonable tangible net benefit" standard, DOBI issued

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216. See *supra* note 58 (noting that when they are charged, points and fees for prime market loans average 1.1%).

217. See *supra* text accompanying notes 146-64.

218. § 46:10B-25(b).

219. See *supra* Part II.C.5.

220. The Act specifically addresses whether a loan that was closed prior to the Act's effective date of November 27, 2003 is deemed to be an existing home loan for the purposes of the Act's flipping provisions. § 46:10B-35(15). The Act deems such a loan an "existing home loan" so long as it meets the Act's definition of a Home Loan. *Id.*; see BULLETIN NO. 03-30, *supra* note 133, at 4.

221. § 46:10B-25(b).

222. *Id.*

guidelines to assist Creditors and, presumably, courts interpreting the Act.<sup>223</sup>

In addition, the Act specifies two additional circumstances in which any “home loan refinancing” is presumed to constitute illegal flipping: (1) where the primary tangible benefit to the borrower is a lower interest rate on the “new loan” and where it will take more than four years for the borrower to recoup her closing costs through the interest rate savings and (2) where the borrower will lose the benefits of a mortgage originated, subsidized or guaranteed by or through a state, tribal or local government, or nonprofit organization and where that mortgage had either (i) a below-market interest rate at the time of origination; or (ii) beneficial non-standard payment terms such as payments that vary with income or are limited to a percentage of income or where no payments are required in certain circumstances.<sup>224</sup>

The language governing these two per se categories of flipping is not as precise as it should be. The text of these subsections refers to a “home loan refinancing” and a “new loan” rather than specifying that the refinancing or new loan at issue be a Covered Home Loan.<sup>225</sup> This plain, broad reading of the Act would not be controversial except that DOBI has taken the position

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223. According to DOBI, “lenders should look at a range of factors related to an individual borrower’s circumstances.” BULLETIN NO. 03-15, *supra* note 125, at 10. DOBI provides the following examples of factors that could be relevant to the reasonable, tangible net benefit assessment:

Terms of the new and old loan, including, but not limited to, note rate, amortization schedule, and balloon payment provisions, provided that costs associated with (and paid at or before closing of) the old loan, such as closing costs or points and fees other than prepayment penalties, are not normally relevant to the determination of flipping;

Costs of the new loan, including points and fees charged on the new loan as well as other closing costs associated with the transaction as routinely disclosed on the closing statement;

Loan-to-value ratio of the new loan compared to that associated with the outstanding balance on the existing home loan;

Debt-to-income ratio of the borrower before and after the proposed transaction;

In cases where economic benefits do not demonstrably indicate that a reasonable, tangible net benefit has occurred, a significant reason that explains the need for, and proposed use of, the loan proceeds; and

Other benefits the borrower receives from the transaction.

*Id.*

In addition, DOBI recommends that the Creditor “obtain an explanation from the borrower regarding any non-economic benefits the borrower associates with the loan transaction.” *Id.*

224. § 46:10B-25(b)(1)-(2).

225. *Id.*



that the Act applies only where the new loan is a Covered Home Loan.<sup>226</sup> Because the general prohibition on flipping applies specifically to Covered Home Loans and because these per se prohibitions are, structurally, included as subsets of the Covered Home Loan flipping prohibitions, the most reasonable reading would conclude that these per se flipping provisions, like the general flipping prohibition, apply only to the category of Covered Home Loans.<sup>227</sup> Under this holistic reading, the anti-flipping prohibitions would not apply to all Home Loans.

### 3. All Home Loans<sup>228</sup>

The following are practices that are prohibited for all Home Loans – including Covered Home Loans and High Cost Home Loans.

#### a. Credit Insurance

HOSA prohibits Creditors from financing any credit insurance along with Home Loans.<sup>229</sup> For the reasons already described, the packing of financed credit insurance premiums has become a huge financial boon to certain lenders without providing any reasonable benefit to – and, indeed, stripping substantial equity from – the borrowers who are frequently deceived into accepting such insurance.<sup>230</sup> The legislature apparently regarded the practice of financing credit insurance as so valueless that it chose to prohibit it for all Home Loans. Borrowers can still elect credit insurance in which premiums are paid on a monthly installment basis, as long as those premiums are not financed as part of the loan.<sup>231</sup>

#### b. Encouraging Default

The Act prohibits Creditors from encouraging a borrower to default on existing debt through the refinancing of a Home Loan.<sup>232</sup> When a

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226. BULLETIN NO. 03-15, *supra* note 125, at 10.

227. *Id.* at 9; BULLETIN NO. 03-30, *supra* note 133, at 3-4.

228. This includes, as mentioned above, all Covered Home Loans and High Cost Home Loans.

229. § 46:10B-25(a). As previously described, this provision of the Act renders moot section 24(3), requiring the inclusion of the cost of financed credit insurance as part of the points and fees calculation. *See supra* Part III.A.3.a.

230. *See supra* text accompanying notes 67-70.

231. § 46:10B-25(a).

232. *Id.* § 46:10B-25(c).

prospective Creditor encourages default, it unnecessarily puts the borrower at risk of foreclosure and destroys her credit rating. This, in turn, can easily make the borrower overly dependent upon the Creditor, even if the new terms being offered are severely disadvantageous given the borrower's credit profile. The legislature recognized that this practice is so universally coercive and without legitimate economic benefits that it banned the practice for all Home Loans.

### c. Late Payment Fees

The Act also regulates late payment fees that Creditors can charge in relation to all Home Loans in the following ways: (i) no late payment fee may be in excess of 5% of the amount of the payment past due;<sup>233</sup> (ii) late fee payments may only be assessed for a payment past due for 15 days or more;<sup>234</sup> (iii) late fee payments cannot be charged more than once for the same late payment;<sup>235</sup> (iv) no late fee payment may be imposed unless the Creditor notifies the borrower within 45 days following the date the payment was due that a late payment fee had been imposed for a particular late payment;<sup>236</sup> and (v) the Creditor shall treat each and every payment as

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233. *Id.* § 46:10B-25(d)(1).

234. *Id.* § 46:10B-25(d)(2).

235. *Id.* § 46:10B-25(d)(3).

If a late payment fee is deducted from a payment made on the loan, and such deduction causes a subsequent default on a subsequent payment, no late payment fee may be imposed for such default. If a late payment fee has been once imposed with respect to a particular late payment, no such fee shall be imposed with respect to any future payment that would have been timely and sufficient, but for the previous default.

*Id.*

For example, a borrower owes a \$1000 monthly payment to a Creditor due on the first of each month. In April, the borrower pays \$1000 on April 20 and misses the assigned due date by more than 15 days. The Creditor assesses a \$50 late payment fee for April. In May, the borrower pays \$1000 on May 1. The Creditor cannot take \$50 from the May payment, apply it to April's late fee, and assess another late payment fee of \$50 because the borrower paid only \$950 toward May's balance. Instead, and in effect, the borrower cannot pay off the entire loan until that \$50 is also paid off, but otherwise the failure to pay the late payment fee will have no effect on the borrower.

236. *Id.* § 46:10B-25(d)(4). "No late payment fee may be collected from any borrower if the borrower informs the Creditor that nonpayment of an installment is in dispute and presents proof of payment within 45 days of receipt of the Creditor's notice of the late fee." *Id.* Practically, this provision contemplates that the "proof of payment" establish that the payment was in fact timely, although it does not expressly so provide.

posted on the same date as it was received by the Creditor, servicer, Creditor's agent, or at the address provided to the borrower for making payments.<sup>237</sup>

#### d. Discretionary Loan Acceleration

Acceleration provisions are common in loan documents in order to allow a Creditor to demand payment of the total outstanding balance or demand additional collateral before the end of the term of the loan upon material default by the borrower. HOSA bans the commercially unreasonable practice of accelerating a loan at the Creditor's sole discretion.<sup>238</sup> The Act plainly recognizes that a borrower should be able to rely upon a contractual payment schedule and not be subject to foreclosure upon a Creditor's whim.

#### e. Payoff Letter

Where a borrower seeks information on a loan's remaining payoff balance, the Creditor must provide it within seven business days of the borrower's request free of charge.<sup>239</sup> This limits the excessive fees that some lenders have taken to charging for a simple and low-cost request.

### 4. What HOSA Fails to Regulate

HOSA is also notable for its failure to directly regulate two very common features of predatory loans. First, HOSA does not address the predatory practice of asset-based lending; it does not require, in any direct way, that Creditors consider a borrower's ability to repay a High Cost Home

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237. *Id.* § 46:10B-25(d)(5). It appears that the Creditor must post a payment as received even if it is sent to any address of the Creditor, servicer or the Creditor's agent other than the one indicated for the making of payments. This seems odd in that it allows the Creditor to effectively delay payment. DOBI has taken the position that for depository institutions, the word "date" shall mean "banking day," which would typically mean by the end of the early afternoon on any given weekday. BULLETIN NO. 03-30, *supra* note 133, at 6-7. For other financial service providers, DOBI will construe "date" to mean "any day that the provider is open for business provided that the payment is received before the close of business hours." *Id.* at 7.

238. § 46:10B-25(4)(e). "This provision does not prohibit acceleration of the loan in good faith due to the borrower's failure to abide by the material terms of the loan." *Id.*

239. *Id.* § 46:10B-25(f).

Loan.<sup>240</sup> HOEPA currently prohibits lenders from extending credit without regard to a borrower's ability to repay,<sup>241</sup> but only in cases where the lender engages in a "pattern or practice" of such activity.<sup>242</sup> The Consumer Fraud Act's prohibition on unconscionable commercial conduct could arguably reach certain instances of asset-based lending; however, a requirement that a Creditor consider a borrower's ability to repay based on her income rather than the equity in her home, akin to provisions of a number of other state statutes addressing predatory lending,<sup>243</sup> would have been an important supplement to HOEPA's limited protections for New Jersey Home Loan borrowers.

Second, the Act does not directly regulate the common predatory practice of levying prepayment penalties on High Cost Home Loans.<sup>244</sup> Virtually all of the states' statutes that have chosen to aggressively respond to the problem of predatory lending have either banned or substantially limited prepayment penalties that can be charged with high cost loans.<sup>245</sup>

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240. See *supra* text accompanying notes 54-57 (describing lending without ability to repay as a central component of many predatory loans).

241. HOEPA defines this conduct as extending credit "based on the consumers' collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations, and employment." 15 U.S.C. § 1639(h) (2000).

242. Traditionally, the "pattern or practice" element of the prohibition has been a hard one for plaintiffs to satisfy, requiring proof of several instances of prohibited conduct in a short period of time. *Newton v. United Cos. Fin. Corp.*, 24 F. Supp. 2d 444, 457 (E.D. Pa. 1998). The recent amendments have loosened the requirement somewhat, creating a presumptive violation where the lender has failed to document and verify the borrower's ability to pay. Truth in Lending, 66 Fed. Reg. 65,604, 65,606 (Dec. 20, 2001) (to be codified at 12 C.F.R. pt. 226). The amended rule seeks to strengthen HOEPA's prohibition on making loans based on homeowners' equity without regard to repayment ability. *Id.* It "creates a presumption that a creditor has violated the statutory prohibition on engaging in a pattern or practice of making HOEPA loans without regard to repayment ability if the creditor generally does not verify and document consumers' repayment ability." *Id.*

243. See, e.g., 2003 ARK. ACTS 2598(k)(1) (requiring lenders to evaluate borrower's ability to repay but setting no percentage of debt-to-income ratio that would presumptively establish such ability); CAL. FIN. CODE § 4931(f)(1) (West 2003) (same prohibition but setting ratio at 55%); MASS. REGS CODE tit. 209, § 32.00 (5)(a) (2003) (requiring lenders to evaluate certain lower-income borrowers' ability to repay and setting ratio at 50%); N.C. GEN. STAT. §24-1.1E (7)(c)(2) (2003) (prohibiting lending without considering borrower's ability to repay, but presuming such ability exists if monthly debt-to-income ratio is 50% or lower).

244. See *supra* text accompanying notes 61-65 (discussing ways in which prepayment penalties can be abusive when made in connection with high cost loans).

245. See, e.g., 2003 ARK. ACTS (3)(m) (prohibiting financing of prepayment fees or penalties); CAL. FIN. CODE § 4970(a)(1) (West 2003) (limiting or barring prepayment fees

HOEPA also bans the practice under certain circumstances.<sup>246</sup> The absence of a direct prohibition on prepayment penalties in HOSA can be attributed to the existence of another pre-existing New Jersey statute that entitles a borrower to prepay a mortgage loan without penalty.<sup>247</sup> In addition, HOSA does indirectly regulate prepayment penalties by forbidding Creditors from financing fees when refinancing a High Cost Home Loan already held by that Creditor.<sup>248</sup>

### *C. Liability Under the Act*

The liability provisions of the Act are somewhat complex but allow for substantial damages against Creditors who violate them. Notably, New Jersey is now one of only a handful of states that has extended liability broadly to assignees of certain home loans.<sup>249</sup> Indeed, the scope of the Act's assignee liability provisions is broad enough to alter the dynamic of secondary market financing of High Cost Home Loans. As a result, the Act's assignee liability provisions are likely to dry up much of the funding for predatory loans in New Jersey.

#### *1. Creditor Liability*

Section 8 of the Act provides for both damages and equitable relief against Creditors who violate the Act's provisions. First, a violation of the

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depending on proximity to closing date); GA. CODE ANN. § 7-6A-5 (1)(A), (B) (2003) (limiting or barring prepayment fees depending on proximity to closing date); N.C. GEN. STAT. § 24-1.1E (c)(3)(a) (2003) (prohibiting all prepayment penalties).

246. Specifically, HOEPA prohibits the imposition of prepayment penalties unless the creditor can demonstrate that: (1) the loan will not cause the borrower to pay more than 50% of gross monthly income toward "monthly indebtedness payments"; (2) the borrower's income and expense are verified by a financial statement signed by the borrower and by a credit report; (3) the creditor is not refinancing either its own or an affiliate's loan; (4) it is imposed only during the first five years of the mortgage; and (5) the prepayment penalty is otherwise legal under state law. *See* 15 U.S.C. § 1639(c)(2)(A)-(D) (2000).

247. N.J. STAT. ANN. § 46:10B-2 (West 2003) ("Prepayment of a mortgage loan may be made by or on behalf of a mortgagor at any time without penalty."). However, in *Shinn v. Encore Mortgage Services, Inc.*, 96 F. Supp. 2d 419, 422 (D.N.J. 2000), a court held that this statutory bar on prepayment penalties was preempted as to "alternative mortgage transactions," such as adjustable rate mortgages, by the federal Alternative Mortgage Transactions Parity Act of 1982, 12 U.S.C. §§ 3801-06 (2000). *Id.* at 423.

248. *See supra* note 67.

249. *See, e.g.*, 2003 N.M. Laws 436; N.Y. BANKING LAW § 6(l) (McKinney Supp. 2004).

Act is deemed a per se violation of the New Jersey Consumer Fraud Act.<sup>250</sup> Accordingly, a borrower may elect to seek damages under *either* (i) the Consumer Fraud Act, which mandates treble damages – itself a strong remedy – and attorneys fees,<sup>251</sup> or (ii) HOSA, which provides for statutory damages for material violations equal to all finance charges agreed to in the home loan agreement, plus up to 10% of the amount financed.<sup>252</sup> In addition to this election, a borrower may be entitled to recover punitive damages for egregious violations, costs and reasonable attorney's fees.<sup>253</sup> The structure of this damages election, which requires borrowers to choose between the Consumer Fraud Act's treble damages provision or the Act's statutory damages and potential punitive damages, gives HOSA one of the strongest consumer protection remedies in New Jersey.

Second, the Act authorizes broad equitable relief.<sup>254</sup> Thus, borrowers may, in addition to seeking damages, assert violations of the Act as a defense to a Creditor's foreclosure action. Where Creditors commit material violations, borrowers may thereby be entitled to extinguish their entire obligation under the predatory loan.<sup>255</sup>

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250. N.J. STAT. ANN. § 46:10B-29(a) (West 2003).

251. *Id.* § 56:8-19.

[In a Consumer Fraud Act action,] the court shall, in addition to any other appropriate legal or equitable relief, award threefold the damages sustained by any person in interest. In all actions under this section, including those brought by the Attorney General, the court shall also award reasonable attorneys' fees, filing fees and reasonable costs of suit.

*Id.*

252. *Id.* § 46:10B-29(a), (b)(1).

253. *Id.* § 46:10B-29(b)(1)(b)-(c). Importantly, the Act expressly states that its penalty provisions are cumulative, not exclusive of, other remedies a borrower may have. *Id.* § 46:10B-30. Borrowers may therefore still assert causes of action under TILA; HOEPA; the Real Estate Settlement Procedures Act, 12 U.S.C. §§ 2601-2617 (2000); common law fraud; unconscionability doctrines and the like.

254. § 46:10B-29(b)(2).

255. *See id.* The Act also contains a catch-all and somewhat ambiguous provision that makes it a violation of the Act to circumvent in bad faith the application of the Act by either (i) dividing a loan transaction into separate parts or (ii) using any other subterfuge with the intent to evade the Act. *Id.* § 46:10B-27(c). The catch-all provision may reflect a legislative concern about not anticipating all potentially unscrupulous lending practices as they may appear in the future. *Cf.* Eric Posner & Richard Haynes, *The Law and Economics of Consumer Finance*, 4 AM. LAW & ECON. REV. 162 (2003) (arguing that much consumer protection legislation is rendered ineffective by their targets' ability to circumvent black letter prohibitions). The provision appears intended to prevent the secondary market from structuring residential mortgage backed securities pools to separate the flow of income from

The time in which such claims can be brought against Creditors is perplexing at first read in large part because the Act fails to specify a statute of limitations period except in certain narrow instances. In general, however, causes of action under the Act have a six-year statute of limitations; however, the Act provides for a virtually unlimited statute of limitations period for borrowers asserting claims or defenses in response to foreclosure, collection or debt acceleration actions brought by Covered Home Loan or High Cost Home Loan Creditors.<sup>256</sup>

The general Creditor liability provisions contained in section 8 appear to be limited by two provisions of the Act that impose caps on damages and which are placed in unrelated sections of the Act. First, section 6 of the Act, which predominantly deals with assignee liability considerations, imposes a cap on the general Creditor damages election, by limiting damages to: (i) the amount already paid on the loan; (ii) remaining liability; plus (iii) costs and attorney's fees, for actions against manufactured home loan and home improvement loan Creditors who have worked in tandem on the borrower's loan with the seller of the manufactured home or home improvements (Sales and Services Creditors).<sup>257</sup> Perhaps the best way of understanding this apparent limitation on the general liability provision, is to construe the section 6(a) provision as a cap on damages only as against the narrow category of Sales and Services Creditors. Borrowers would be entitled to pursue the broader, general election of damages under section 8 against all other Creditors.<sup>258</sup>

Second, section 6(c) of the Act also appears to impose a damages cap for Covered Home Loans and High Cost Home Loans that limits the Act's

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New Jersey Home Loans from the potential liability that might accrue from such loans that violate the Act. *See* § 46:10B-27(e).

256. The Act's statute of limitations provisions are best understood by recognizing that HOSA is enacted against the background of New Jersey's default statute of limitations provisions of six years for tort causes of action. § 2A:14-1. Consistent with this understanding, certain provisions of HOSA expressly limit the time in which to bring a cause of action. *See id.* § 46:10B-27(c)(1) (providing six-year statute of limitations for original actions brought against assignees of Covered Home Loans); *id.* § 46:10B-27 (c)(1)-(2) (providing statute of limitations period equal to the term of the loan, for Covered Home Loans and High Cost Home Loan borrowers asserting claims or defenses, brought in an individual capacity only, that seek certain equitable relief). For all other causes of action under HOSA, New Jersey's default tort statute of limitations of six years should apply.

257. *Id.* § 46:10B-27(a).

258. An alternative reading would authorize borrowers to choose to sue the subcategory of Sales and Services Creditors for damages under either the Consumer Fraud Act, section 46:10B-29(b)'s statutory damages provisions, or section 46:10B-27(a)'s recoupment provision, whichever is the greater.

general Creditor liability provisions. Section 6(c) limits damages against a Covered Home Loan or a High Cost Home Loan “creditor or subsequent holder or assignee of the home loan,” to a borrower’s remaining obligation under the loan plus costs and attorney’s fees.<sup>259</sup> The additional reference to “creditor” liability in a section of the Act that deals primarily with assignee liability, and which would have the potential effect of limiting damages otherwise generally available against Creditors, is unexpected.

Beyond the possibility that this phrasing is a mere drafting error, the best way to reconcile the apparent limitation on Creditor liability contained in section 6 with the general Creditor liability provisions in section 8 is by reading the Act as providing a choice of damages between these sections, which can be exercised by a borrower depending upon the time in which the action is brought. The general Creditor liability and damages provisions of section 8 apply to actions brought within the statute’s default six-year statute of limitations.<sup>260</sup> The cap on Creditor damages would apply to equitable claims and defenses to foreclosure, collection or debt acceleration actions that section 6 authorizes a borrower to assert *at any time* during the term of the loan.<sup>261</sup> Thus, if a borrower brings an original action within six years of a Covered Home Loan closing, that borrower can sue for damages either under section 6 or under section 8.<sup>262</sup> After six years, however, a borrower could assert a response (as a claim, counterclaim, or defense) to a collection, foreclosure or debt acceleration action brought by either a High Cost Home Loan or Covered Home Loan Creditor, and collect under the limited damages provided by section 6. Under this reading, borrowers typically would use section 6 against creditors for disputes arising six years after a Covered Home Loan or High Cost Home Loan closing and would typically

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259. *Id.* § 46:10B-27(c) (emphasis added).

260. *See supra* text accompanying note 256.

261. *See* § 46:10B-27(c)(1) (authorizing borrowers to assert at any time a defense, claim or counterclaim against Covered Home Loan creditors, in response to foreclosure or collection action, debt acceleration, or following borrower’s sixty-day default).

262. In most circumstances, the general Creditor damages provisions contained in section 8 would be greater than “the amount required to reduce or extinguish the borrower’s liability under the loan” for which a borrower can sue under section 6. However, there are certain circumstances, such as where a lawsuit is commenced immediately after the origination of a prohibited loan and where a borrower has not yet accrued significant finance charges, in which damages under section 6 would be greater. Section 46:10B-27(c)(1) says nothing about limiting damages on High Cost Home Loans. Accordingly, an original action brought within six years of a High Cost Home Loan closing should be governed by section 8 exclusively.



use the general Creditor liability provision of section 8 to bring original claims against such Creditors within six years of the closing.

## 2. Assignee Liability

The Act includes an express assignee liability provision in order to partially abrogate the scope of the Holder in Due Course doctrine and thereby increase the reach of the Act's remedies and defenses. As previously described, the Holder in Due Course doctrine frequently imposes a substantial impediment to borrowers who seek redress for their predatory loans, because it shields good faith purchasers and assignees of those loans from liability for even the most outrageous conduct by the originating lenders.<sup>263</sup> Because many predatory lenders depend for their financing on the securitization of their mortgage pools and subsequent sale on the secondary markets,<sup>264</sup> the Act's assignee liability provisions are meant to reduce resources available to originators of those loans who violate the Act. The assignee liability provisions, like the Act's prohibitions themselves, depend upon how a loan is classified.

### a. High Cost Home Loans

Two provisions regulate assignee liability for High Cost Home Loans. The first provision allows a borrower to assert any and all affirmative claims for damages – including the general damages election described above – or defenses that she may have against the original High Cost Home Loan Creditor.<sup>265</sup> As such, this assignee liability provision is a complete abrogation of the Holder in Due Course doctrine for High Cost Home Loans. A borrower of a High Cost Home Loan can, therefore, assert any affirmative claim for damages available under section 8 of the Act, including damages under the Consumer Fraud Act or statutory damages, as well as any available claims or defenses, including strong defenses to foreclosure, equally against *both* the Creditor *and* the subsequent purchaser. The statute of limitations period for such claims would be six years.<sup>266</sup>

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263. See *supra* text accompanying notes 118-23.

264. See *supra* text accompanying notes 33-39.

265. See § 46:10B-27(a) (providing that purchaser or assignee of High Cost Home Loan is "subject to all affirmative claims and any defenses with respect to the loan that the borrower could assert against the original creditor or broker of the loan").

266. See *supra* text accompanying note 256.

While this abrogation of the Holder in Due Course doctrine is sweeping, the Act does provide certain safe harbors for those assignees who did not intend to invest in High Cost Home Loans. The safe harbor is available to an assignee who can demonstrate that, employing “reasonable due diligence,” it could not have determined that the purchased loan was a High Cost Home Loan.<sup>267</sup> This safe harbor provides a variety of simple and low-cost ways for assignees and purchasers to preserve traditional Holder in Due Course defenses for High Cost Home Loans that they inadvertently purchase. But for those who fail to comply with the safe harbor provisions or who intend to invest in High Cost Home Loans, the Act does abrogate the Holder in Due Course doctrine and subjects them to all claims and defenses available against the originating Creditors. In order to avoid potential liability, therefore, secondary market actors will either avoid purchasing High Cost

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267. § 46:10B-27(b). The Act sets forth a basis for a purchaser or assignee to be given a presumption that it has exercised such due diligence. The purchaser or assignee must demonstrate by a preponderance of the evidence that it:

- (1) has in place at the time of the purchase or assignment of the loan, policies that expressly prohibit its purchase or acceptance of assignment of any high cost home loan;
- (2) requires by contract that a seller or assignor of home loans to the purchaser or assignee represents and warrants to the purchaser or assignee that either
  - (a) it will not sell or assign any high cost home loan to the purchaser or assignee or
  - (b) that the seller or assignor is a beneficiary of a representation and warranty from a previous seller or assignor to that effect; and
- (3) exercises reasonable due diligence at the time of purchase or assignment of home loans or within a reasonable period of time thereafter intended by the purchaser or assignee to prevent the purchaser or assignee from purchasing or taking assignment of any high cost home loan.

*Id.*; see also BULLETIN NO. 03-30, *supra* note 133, at 1-2.

The Act does not specifically define “reasonable due diligence.” DOBI has taken the position that reasonable due diligence does not typically require an assignee to review every loan being purchased:

The Department considered the concept of “reasonable due diligence” as generally understood by courts, which is “what a reasonable person would have done in his situation given the same information.” The Department is in the process of reviewing common banking and secondary market practices regarding due diligence review of mortgage pools, as well as similar due diligence in the securities context, and believes, based on the information it has obtained to date, that sampling is a standard accepted practice.

BULLETIN NO. 03-15, *supra* note 125, at 8; see also BULLETIN NO. 03-30, *supra* note 133, at 3 (indicating that upgraded due diligence should be conducted if High Cost Home Loans are found in pools for which there are representations that no such loans are contained in such pools).

Home Loans altogether by complying with the safe harbor provision or undertake the due diligence required to purchase only those High Cost Home Loans that do not violate any of the Act's provisions.

The second assignee liability provision applies to an assignee that meets the criteria entitling it to the protections of the Act's safe harbor provisions, but with limited potential damages. Against assignees that meet the Act's safe harbor provisions, a borrower can still assert any equitable claims and defenses to the assignee's foreclosure or collection action that it could have raised against the original creditor.<sup>268</sup> While such defenses can be asserted against a foreclosing or collecting High Cost Home Loan assignee, at any time during the term of the loan, damages are limited to the borrower's remaining obligation under the loan plus costs and attorney's fees.<sup>269</sup>

#### b. Covered Home Loans

The Act does not fully abrogate the Holder in Due Course doctrine (and thereby authorize maximum liability) for assignees of Covered Home Loans in the way that it does for the assignees of High Cost Home Loans that fail to meet the safe harbor provision.<sup>270</sup> Specifically, section 46:10B-27(c) provides for limited damages against assignees of Covered Home Loans in the amount of the remaining obligation under the loan, plus costs and attorney's fees.<sup>271</sup> Within six years of the closing of a Covered Home Loan, a borrower can bring such claims in an original action;<sup>272</sup> during the entire term of the loan, however, a borrower can assert claims or defenses in

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268. § 46:10B-27(b)(2). This section would also allow a borrower to bring an original claim against a High Cost Home Loan assignee after the assignee (i) initiated a collection or foreclosure action; (ii) accelerated the loan debt; and, notably (iii) after the loan debt has become sixty days in default. *Id.* This final ground is notable because it is the only circumstance in which borrowers would not have to wait for action by a High Cost Home Loan assignee to commence a lawsuit, but could trigger authorization to sue by deliberately going into sixty-day default.

269. *Id.* § 46:10B-27(c).

270. *Cf. id.* § 46:10B-27(b) (entitling borrowers to assert against assignees of High Cost Home Loans any and all claims that could have been asserted against a High Cost Home Loan creditor, unless the assignee meets the Act's safe harbor provisions).

271. *Id.* § 46:10B-27(c). This provision limiting damages to those suing in an individual capacity would, of course, prohibit class actions under this subsection of the Act.

272. *Id.* § 46:10B-27(c)(1).

response to a collection, foreclosure or debt acceleration action brought by a Covered Home Loan assignee.<sup>273</sup>

c. Home Loans

The Act's assignee liability provisions are more limited for Home Loans and appear to be based on the FTC Holder in Due Course rule (the FTC Holder Rule).<sup>274</sup> Liability for holders of Home Loans applies only to those loans made in connection with a manufactured home or home improvement contract and offering slightly limited damages. Accordingly, if a Home Loan "was made, arranged, or assigned by a person selling either a manufactured home, or home improvements to the dwelling of a borrower, or was made by or through a Creditor to whom the borrower was referred by such seller, the borrower may assert all affirmative claims and any defenses that the borrower may have against the seller or home-improvement contractor."<sup>275</sup> That is, if either a manufactured home seller or a home improvement contractor is working in tandem with a Creditor, the borrower may assert any claims or defenses it has against the former in an action brought against (or brought by) the ultimate holder of the Home Loan.<sup>276</sup>

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273. *Id.* § 46:10B-27(c)(1). As with the provision for High Cost Home Loan assignee liability, this section would also allow a borrower to bring an original claim against a Covered Home Loan assignee after the assignee (i) initiated a collection or foreclosure action; (ii) accelerated the loan debt; and, notably (iii) after the loan debt has become sixty days in default. *Id.*; see also *supra* note 266.

274. See *supra* text accompanying notes 118-23.

275. § 46:10B-27(a).

276. Although the Act does not address how much involvement a home improvement contractor or manufactured home seller must have in arranging a Home Loan for section 46:10B-27(a) to apply, DOBI has taken the position that

the requisite level of involvement will be reached if the contractor or seller is sufficiently involved in making or otherwise participating in the home loan as consistent with the substantial guidance and precedent that underlies the FTC Holder Rule. For example, the circumstances in which a home improvement contractor will be determined to have "referred" a borrower to a lender under [section] 46:10B-27a, will include "those situations where a [home repair] seller, in the ordinary course of business, is sending his buyers to a particular loan outlet, or to particular outlets, for credit which is to be used in the sellers' establishment. In such circumstances, the seller is effectively arranging credit for his customers."

BULLETIN NO. 03-15, *supra* note 125, at 5-6 (citations omitted).

DOBI will use the FTC Holder Rule definition of "seller" in determining who would qualify as a "person selling either a manufactured home or home improvements" under the Act. BULLETIN NO. 03-30, *supra* note 133, at 5. "Seller" is there defined as a "person who, in

### 3. Defenses

The Act provides significant good faith defenses to liability for Creditors in order to encourage Creditors to correct potentially illegal loan terms on their own. Specifically, Creditors acting in good faith who fail to comply with the Act may escape liability under the Act if the Creditor: (i) within 45 days of the loan closing, makes restitution to the borrower and adjusts the loan; or (ii) within 90 days of the loan closing and prior to receiving any notice from the borrower of the compliance failure, notifies and makes restitution to the borrower and adjusts the loan.<sup>277</sup> The latter defense is available only where the compliance failure was unintentional and resulted from a bona fide error, notwithstanding the maintenance of procedures reasonably adopted to avoid such errors.<sup>278</sup> These provisions encourage Creditors to conduct post-closing due diligence and correct unintentional violations of the Act.

## IV. EVALUATING THE ACT'S EFFECTIVENESS

Throughout the period of the Act's consideration in the New Jersey legislature and lingering still is the important concern as to whether the Act's provisions will have the unintended and harmful consequence of reducing the availability of legitimate, desired subprime credit in the state. We believe that the Act will not materially reduce the availability of such credit.

### A. *The Continued Availability of Subprime Credit in New Jersey*

A persistent objection leveled against HOSA and other, similar efforts to regulate high cost loans is that they are ultimately counterproductive. Critics

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the ordinary course of business, sells or leases goods or services to consumers." 16 C.F.R. § 433.1(j) (2003).

277. § 46:10B-29(c). The Act preempts all municipality, county or political subdivision ordinances, resolutions, or any other rules or regulations related to Home Loan lending practices. *Id.* § 46:10B-34. The lending industry regarded the inclusion of the preemption clause as a significant victory. They argued that multiple layers of regulation adds to lenders' compliance costs and increases the risk of unintentional statutory violations. *See, e.g.,* Press Release, Origination News, MBANJ Backs Compromise (Apr. 2003), *available at* <http://www.acorn.org/campaigns/pc.php?p=2111>.

278. § 46:10B-29(c). "Examples of bona fide errors include clerical, calculation, computer malfunction and programming, and printing errors. An error of legal judgment with respect to a person's obligations under this section is not a bona fide error." *Id.*

argue that such regulations make it both so risky and costly to make higher cost loans that many subprime lenders will abandon subprime lending entirely, leaving subprime borrowers without sufficient access to home equity credit.<sup>279</sup> This concern, however, appears to be largely overstated. Based on the dynamics of the subprime lending market and the experience of other states, HOSA will probably discourage the origination of many predatory, high cost loans while leaving an ample supply of subprime credit available for this still lucrative market. Indeed, it may be that the Act does not go far enough: HOSA's high cost loan triggers could have been set even lower to bring in a greater proportion of loans within its scope of its more restrictive provisions without causing a harmful reduction in legitimate subprime lending.

First, a central premise of the concern over the Act's possible undermining of legitimate subprime lending – that the higher costs associated with making subprime loans under HOSA will make their extension unprofitable<sup>280</sup> – appears flawed. As an initial matter, HOSA's High Cost Home Loan APR trigger – 8% above the prevailing Treasury rate – is still very high. Nationally, subprime loans have interest rates that average 2.5% to 4% above prime mortgage rates.<sup>281</sup> Thus, HOSA's High

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279. See, e.g., Kelly K. Spors, *Subprime Bill Aims to Mute State Laws: Republican's Proposal to Police Predatory Lending Would Set Weaker National Standards*, WALL ST. J., Feb. 14, 2003, at A4.

The subprime-lending industry complains that local regulation is confusing and counterproductive. For example, legislation enacted in Georgia makes anyone who winds up owning the loans – including Fannie Mae and Freddie Mac – liable for lending violations. As a result, Fannie and Freddie have stopped buying some loans made in Georgia. Standard & Poor's and Moody's Investors Service have said they will no longer rate mortgage-backed securities that include loans covered by the law, and some subprime lenders say they have pulled certain products out of the market there.

*Id.*

280. See RICHARD F. DEMONG, NAT'L HOME EQUITY MORTGAGE ASS'N, THE POTENTIAL IMPACT OF THE NEW JERSEY HOME OWNERSHIP SECURITY ACT OF 2002 (2003) (study conducted prior to S&P decision to rate most New Jersey home loans, concluding that HOSA will drive many major subprime lenders from New Jersey), at <http://www.nhema.org/press.asp?bid=517> (Nov. 26, 2003); see also Chris Gosier, *New Mortgage Law Hits Home Differently With Lenders, Buyers*, DAILY RECORD, Nov. 17, 2003, available at <http://www.dailyrecord.com/news/articles/news2-mortgagelaw17.htm>.

281. See *supra* text accompanying notes 17-18.

Cost Home Loan prohibitions will affect only a relatively small proportion of the subprime lending market and at rates that are already high.<sup>282</sup>

In addition, as highlighted elsewhere, studies of the subprime market demonstrate a low correlation between a borrower's credit risk and mortgage pricing, which would suggest a significant range of subprime lending profitability at rates below HOSA's High Cost Home Loan triggers.<sup>283</sup> Underwriting standards among different subprime lenders vary greatly, as do underwriting standards within a particular lending entity over time.<sup>284</sup> As a result, and very much unlike the prime market, the range of pricing of subprime loans varies so greatly – between 3.00% and 19.99% in 1999 according to one study<sup>285</sup> – that subprime lending rates cannot consistently or accurately account for legitimate credit risk variations and very likely reflect a strong bias toward overpricing.<sup>286</sup>

Indeed, studies by both government sponsored entities and the subprime industry itself demonstrate that a substantial proportion of subprime borrowers are currently highly overcharged for their mortgages. The chairman of Fannie Mae estimated that in 2000 approximately 50% of all subprime borrowers could have qualified for a lower cost prime loan based on their credit risk.<sup>287</sup> A 1996 industry-sponsored poll of 50 of the then-

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282. Evidence suggests that HOEPA's 8% APR trigger is too high to cover a significant proportion of potentially abusive subprime loans. JOINT HUD-TREASURY REPORT, *supra* note 8, at 85.

283. See MANSFIELD, *supra* note 18, at 536 (arguing that pricing in the subprime market "does not appear to be based on a legitimate assessment of risk").

284. See WEICHER, *supra* note 16, at 34-35 (describing substantial variety of underwriting criteria among subprime lending entities and within individual firms over time, which can result in large discrepancies in pricing to similarly-situated borrowers).

285. Mansfield, *supra* note 18, at 536. In contrast, prime loans around that period fell into a range of under 2%. *Id.*

286. *Id.* at 544-45 ("[I]t is not clear that pricing in the subprime market has any basis at all. Lenders will not carefully correlate price to risk when they can just as easily charge whatever rate they choose."). One study estimated that charging interest rates higher than justified by a borrower's credit risk costs American borrowers \$2.9 billion annually. STEIN, *supra* note 5, at 9-11. But see GREGORY ELLIEHAUSEN & MICHAEL STATEN, REGULATION OF SUBPRIME MORTGAGE PRODUCTS: AN ANALYSIS OF NORTH CAROLINA'S PREDATORY LENDING LAW 14-15 [hereinafter ELLIEHAUSEN STUDY] (Georgetown Univ., Working Paper No. 66, 2002) (suggesting that data in North Carolina reveals that allegedly predatory loans are priced to reflect risk), available at <http://www.msb.edu/prog/crc/pdf/RevisedWP66.pdf> (Nov. 2002).

287. *Fannie Mae has Played Critical Role in Expansion of Minority Homeownership Over Past Decade, Raines Pledges to Lead Market for African American Mortgage Lending*, BUS. WIRE, Mar. 2, 2000, LEXIS, Nexis Library, UPI File.

most active subprime lenders came to a similar conclusion.<sup>288</sup> Accordingly, even if HOSA eliminates a majority of High Cost Home Loans in New Jersey, legitimate subprime lenders and even prime lenders will find a large, profitable range in which they would be willing to extend credit to traditional subprime borrowers. Indeed, the above analysis suggests that pricing of subprime lending is sometimes so highly uncorrelated to credit risk and biased upward that HOSA APR triggers could be set even lower without jeopardizing the provision of subprime credit in New Jersey.<sup>289</sup>

Second, the experience of other states that have enacted similar high cost loan regulations demonstrates that HOSA's attempts to diminish abusive lending practices will not destroy the legitimate subprime lending-market. In 1999, North Carolina became the first state to enact a comprehensive law to address predatory lending abuses in the residential mortgage market.<sup>290</sup> The North Carolina law is substantially similar to HOSA because it prohibits loan terms and practices in connection with high cost loans – which North Carolina defined at 10% higher than comparable Treasury rate and/or points and fees in excess of 5% of the total loan amount.<sup>291</sup> The North Carolina act prohibits, among many other things, financing of any points or fees, balloon payments, negative amortizations, loan flipping without reasonable, tangible net benefit to the borrower, prepayment penalties, and lending without regard to the borrower's ability to repay.<sup>292</sup>

Recent studies undertaken to evaluate the impact of the law on North Carolina's residential mortgage market find some reduction in subprime loan originations following its implementation, but differ on the significance of that reduction. One study conducted by researchers at the University of North Carolina (the Quercia Study) finds that the law operated almost

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288. *Half of Subprime Loans Categorized as "A" Quality*, INSIDE B&C LENDING, June 10, 1996, at 7-8.

289. In deciding to lower the HOEPA trigger from 10% to 8% in 2001, the Federal Reserve Board concluded that there would still be a significant market for credit available to subprime borrowers. Federal Reserve Board Commentary on Proposed Amendments to Regulation Z, 66 Fed. Reg. 65,604, 65,607 (Dec. 20, 2001) (to be codified at C.F.R. pt. 226) ("Data submitted by a trade association representing nondepository institution lenders suggest that there is an active market for HOEPA loans under the current APR trigger. There is no evidence that the impact on credit availability will be significant if the trigger is lowered."). That conclusion has been borne out and may also suggest that an even lower APR trigger would still accommodate substantial subprime lending activity.

290. N.C. GEN. STAT. § 24-1.1A (1999).

291. *Id.* § 24-1.1E(6)(b).

292. *Id.* § 24-1.1A(7)(c)(2).



exactly as intended.<sup>293</sup> The Quercia Study concluded that loan originations with predatory features decreased substantially in North Carolina after the law's enactment,<sup>294</sup> but did not materially decrease either the supply of subprime credit to low-income borrowers or the diversity of subprime mortgage products traditionally extended to them.<sup>295</sup>

The Quercia Study attempted to improve upon the methodology of an earlier study conducted by the researchers at Georgetown University's School of Business (the Elliehausen Study) which had concluded that the North Carolina law caused a 14% decline in subprime originations in the state, a decline the study concluded fell disproportionately on the state's lowest-income borrowers.<sup>296</sup> There are some notable differences between the methodology employed by both studies. Specifically, the Quercia Study relied on loan data that covered an additional period of almost two years after the North Carolina act's enactment and also compared the North Carolina loan data to data obtained from all fifty states, rather than comparing the North Carolina loan data to the four neighboring states examined by the Elliehausen Study.<sup>297</sup> Perhaps more importantly, the

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293. See ROBERTO G. QUERCIA ET AL., UNIV. OF N.C. AT CHAPEL HILL, *THE IMPACT OF NORTH CAROLINA'S ANTI-PREDATORY LENDING LAW: A DESCRIPTIVE ASSESSMENT* (2003), available at [http://www.kenan-flagler.unc.edu/assets/documents/CC\\_NC\\_Anti\\_Predatory\\_Law\\_Impact.pdf](http://www.kenan-flagler.unc.edu/assets/documents/CC_NC_Anti_Predatory_Law_Impact.pdf) (June 25, 2003); see also KEITH ERNST ET AL., CTR. FOR RESPONSIBLE LENDING, *NORTH CAROLINA'S SUBPRIME HOME LOAN MARKET AFTER PREDATORY LENDING REFORM* (2002), available at [http://www.mortgagebankers.org/state\\_update/2002/nc/nc\\_study\\_0814.pdf](http://www.mortgagebankers.org/state_update/2002/nc/nc_study_0814.pdf).

294. See QUERCIA ET AL., *supra* note 293, at 18-20, 36-38 tbls.11-13 (documenting North Carolina's comparative decrease in loans containing prepayment penalties, balloon payments and exceedingly high loan-to-value ratios); see also ERNST ET AL., *supra* note 293, at 8-9 (documenting post-enactment decrease in flipped loans without reasonable, tangible net benefit to the borrower of 7%, decrease in "excess fees" of 25%, decrease in single premium credit insurance of 20%, decrease in incidence of loans with prepayment penalties of 35%, and estimating that the law saved North Carolina homeowners a total of \$100 million).

295. See QUERCIA ET AL., *supra* note 293, at 12-21 (concluding that the subprime lending market in North Carolina is still large and vibrant after the law's enactment, that a substantial portion of the limited decrease in subprime lending is attributable to the decrease in predatory loans, and that subprime purchase loans actually increased after the law's passage); see also ERNST ET AL., *supra* note 293, at 3-7 (concluding that the subprime market in North Carolina is still very strong after the act's passage, that the proportion of subprime lending to lowest-income borrowers actually increased after the law's passage, and that there has been no increase in the pricing in subprime loans since the law's passage that might have been associated with a decrease in loan availability).

296. See ELLIEHAUSEN STUDY, *supra* note 286, at 13.

297. Compare QUERCIA ET AL., *supra* note 293, at 10 (analyzing loans originated from 1998 to 2002), with ELLIEHAUSEN STUDY, *supra* note 286, at 9 (analyzing loans originated

Elliehausen Study did not distinguish between desirable and undesirable subprime loans. The North Carolina law prohibits the practice of flipping borrowers from one loan into a new subprime loan, where the new loan offers no reasonable net benefit to the borrower. Thus, part of the purported reduction of subprime mortgage originations in North Carolina may well be attributable to a decrease in unreasonable refinances that the law intentionally targeted.<sup>298</sup> Ultimately, it appears that predatory subprime originations have declined in North Carolina at the same time that the overall subprime market remains healthy.<sup>299</sup>

At the time of publication of this Article, the National Home Equity Mortgage Association (NHEMA) released the results of a study it commissioned along with the National Association of Mortgage Brokers (the NHEMA Study), purporting to quantify a substantial reduction in subprime loan originations in New Jersey following HOSA's passage.<sup>300</sup> The NHEMA Study claims that, in a two month period following the Act's implementation, cash-out refinances in New Jersey decreased 67.2% and the total volume of subprime originations decreased in New Jersey between eight hundred million and one billion dollars.<sup>301</sup> However, the NHEMA

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from January 1, 1997 to June 30, 2000). Since the publication of both studies, commentators have criticized a variety of aspects of the studies' methodologies and data sets. See OCC Working Paper, *supra* note 37 (criticizing Quercia Study); ROBERT E. LITAN, NORTH CAROLINA PREDATORY LENDING LAW: STILL A PROBLEM DESPITE NEW STUDY (2003) (criticizing Quercia Study); NAT'L CONSUMER LAW CTR. ET AL., COMMENTS TO THE OFFICE OF COMPTROLLER OF CURRENCY, BANKING ACTIVITIES AND OPERATIONS; REAL ESTATE LENDING AND APPRAISALS (2003), available at <http://www.naca.net/CommentsOCCNatBnkPreempt.pdf> (Oct. 6, 2003) (criticizing OCC Working Paper); MICHAEL A. STEGMAN ET AL., AEI-BROOKINGS JOINT CTR. FOR REGULATORY STUDIES, NC'S ANTI-PREDATORY LENDING LAW: DOING WHAT IT'S SUPPOSED TO DO: A REPLY 1 (2003), available at <http://aei-brookings.org/admin/authorpdfs/page.php?id=299> (Nov. 2003).

298. See KEITH D. HARVEY & PETER J. NIGRO, DO PREDATORY LENDING LAWS INFLUENCE MORTGAGE LENDING? AN ANALYSIS OF THE NORTH CAROLINA PREDATORY LENDING LAW 25 (2002) (attributing the limited decline of subprime lending in North Carolina to the decrease in loan application rates, not to loan denial rates).

299. See *Lenders Will Try To Pin Down Effects of North Carolina Law*, INSIDE B&C LENDING, Mar. 5, 2001, at 3-5 (reporting that North Carolina lenders were offering full range of mortgage products after the Act's enactment and that there was "little or no variation" in pricing of those products as compared with other neighboring states).

300. RICHARD F. DEMONG, UNIV. OF VA., THE IMPACT OF THE NEW JERSEY HOME OWNERSHIP SECURITY ACT OF 2002 (2004) [hereinafter NHEMA STUDY], available at <http://www.nhema.org/press.asp?bid=596> (Mar. 26, 2004).

301. *Id.*; see also Richard Newman, *Lenders Fear Stifling Effects of Law Targeting Predatory Loans*, THE RECORD, Oct. 26, 2003, at B1 (reporting that five loan originators

Study appears to suffer from methodological flaws<sup>302</sup> and also fails to distinguish between decreases in legitimate subprime lending and predatory lending.<sup>303</sup> Furthermore, the NHEMA Study measured respondents' lending practices over only a two month period – a period that coincided with a wave of enormously negative publicity directed at the law by mortgage lenders, mortgage brokers, NHEMA and other industry groups in a focused effort to have the law substantially revised.<sup>304</sup> As a result, the responses may also have been based upon a misperception of the Act's scope or the Act's liability provisions.<sup>305</sup> However, if North Carolina's experience is in fact instructive, the New Jersey mortgage industry should shortly learn to comply with the Act's requirements and continue to originate legitimate subprime loans sufficient, if slightly diminished, to meet consumer demand.

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doing business in New Jersey plan to curtail their practice of refinancing loans), *available at* 2001 WL 4634599.

302. For instance, the NHEMA STUDY does not take into account the 72% decrease in refinances across the nation during the same period and therefore does not reliably isolate HOSA as the cause for the drop in New Jersey subprime refinancing. *See* MORTGAGE BANKERS ASSOCIATION, RESIDENTIAL MORTGAGE ORIGINATION, PURCHASE, OUTSTANDING, AND MORTGAGE BACKED SECURITY DATA (2003) (demonstrating drop in national refinancing from \$815 billion to \$310 billion between third and fourth quarter of 2003), *available at* <http://www.mortgagebankers.org/marketdata> (last updated Mar. 25, 2004). In addition, the study does not acknowledge the real possibility that the thirteen respondents, out of the twenty-four surveyed, were invested in undercutting the law, which might well cause them to attribute the decrease in their subprime refinances to HOSA's passage rather than to the increase in interest rates that appear to have driven the nationwide decrease in refinances.

303. For example, the study notes that 84% of the lenders and mortgage brokers it surveyed reported that they have reduced "certain types of subprime lending in New Jersey as a result of HOSA." NHEMA STUDY, *supra* note 300, at 2. Naturally, however, this reduction in "certain types of subprime lending" is the expected and desirable effect of the Act's prohibition on predatory practices.

304. Mary P. Gallagher, *Poor Prospects Seen for Bills That Ease Up on Home Mortgage Lenders*, N.J. L.J., Dec. 29, 2003, at 7; Suzette Parmley, *Bills to Dilute N.J. Lending Law Advancing*, PHILA. INQUIRER, Dec. 11, 2003, at A1.

305. *See* Press Release, New Jersey Dep't of Banking and Ins., Mortgage Industry Rebuked Over Predatory Lending Law (Nov. 18, 2003), *available at* <http://www.state.nj.us/dobi/PressReleases/pr111803.htm>. Here, DOBI Director Tillman is quoted as saying:

We also have learned that many of our lenders have wasted their time and money by attending programs or presentations where too much time was spent bashing the new law or pointing out the problems and pitfalls, and not enough time explaining how you could successfully navigate the new rules and continue operating.

*B. The Reaction of the Secondary Market to HOSA*

As previously described, lenders frequently pool together many of their mortgages, and, through structured finance transactions arranged by investment banks, securitize the mortgages and sell them to a variety of investors on the secondary market.<sup>306</sup> This process of securitization has in large part driven the dramatic rise of subprime lending.<sup>307</sup> Prior to their sale, the secondary market demands that such transactions be rated by one or more of the major bond and securities rating agencies – Standard & Poor's Ratings Services (S&P), Fitch, Inc. (Fitch) and Moody's Investors Service, Inc. (Moody's) – to identify the level of risk associated with the pool.<sup>308</sup> The role of such agencies is essential to the operation of the entire subprime mortgage pipeline; indeed, without such a rating from at least one of these agencies, most investors on the secondary market will not buy into a mortgage pool.<sup>309</sup>

Recently, after Georgia passed a predatory lending law that contained a broad assignee liability provision applicable to those loans designated under that statute as high cost, the major rating agencies actually refused to rate residential mortgage-backed securities pools containing *any* loans that originated in Georgia after the effective date of the law.<sup>310</sup> The Georgia law

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306. See *supra* text accompanying note 33.

307. See *supra* text accompanying note 34.

308. See KENNETH G. LORE & CAMERON L. COWAN, MORTGAGE-BACKED SECURITIES § 1.18 (2003); see also Press Release, Standard & Poor's, Evaluating Predatory Lending Laws: Standard and Poor's Explains its Approach (Apr. 15, 2003), available at <http://www.housingchoice.org/news%20stories/04152003.htm>; Press Release, Moody's Investors Service, Inc., Moody's Reports on Impact of Predatory Lending Laws in RMBS (Mar. 26, 2003), available at <http://www.moody.com>.

309. LORE & COWAN, *supra* note 308, § 1.18; see also Jonathan Fuerbringer, *Agencies to Continue to Rate Pools of New York Mortgages*, N.Y. TIMES, Mar. 1, 2003, at C4.

310. See Press Release, Fitch Ratings, Fitch Ratings Declines to Rate Georgia Loans in RMBS Pools, Considers Impact to Other Predatory Lending Legislation (Feb. 5, 2003), available at <http://www.mortgagebankers.org/srchindex.html>; Press Release, Moody's Investors Service, Inc., Moody's Expands Consideration of Assignee Liability for Residential Mortgages in Securitizations (Jan. 30, 2003), available at <http://www.mortgagebankers.org/srchindex.html>; Press Release, Standard and Poor's, Standard and Poor's to Disallow Georgia Fair Lending Act Loans (Jan. 16, 2003), available at <http://www.mortgagebankers.org/srchindex.html>. The credit analysis performed by the rating agencies determines if any of the underlying loans covered by a predatory lending statute may be included in its rating transactions and what, if any, additional credit enhancements may be required. In performing an analysis of structured transactions backed by residential mortgage loans, rating agencies evaluate the impact a predatory lending law might have on the availability of funds to pay investors in the rated securities.

authorized the borrower to assert against the assignee of a high cost loan any and all claims the borrower could have asserted against a creditor but, unlike HOSA, failed to precisely define the differences among the various categories of regulated loans and provided no safe harbor protection for assignees who inadvertently purchased Georgia high cost loans despite having reasonable procedures in place to prevent such purchases.<sup>311</sup>

The rating agencies concluded that Georgia's assignee liability provisions created potentially unlimited damages for purchasers of high cost loans and were thus so risky that they could not be rated.<sup>312</sup> The agencies' announcements caused turmoil among Georgia lenders and signaled the imminent abandonment of financing for residential lending in the state.<sup>313</sup> Soon after, the Georgia legislature amended the statute in an attempt to address the rating agency concerns; specifically, the amended law clarified the distinction between high cost and other loans and included a safe harbor provision to protect assignees that inadvertently purchase high cost loans.<sup>314</sup> As a result, the agencies changed course and announced they would rate Georgia residential mortgages.<sup>315</sup>

After the enactment of HOSA, S&P announced that it would not rate pools that contain certain New Jersey residential loans.<sup>316</sup> S&P claimed that

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311. See GA. CODE ANN. § 7-6A-1 to -13 (2003); see also NATALIE ABRAMS & MAUREEN COLEMAN, STANDARD & POOR'S, STANDARD & POOR'S ADDRESSES NEW JERSEY PREDATORY LENDING LAW 3-4 (2003), available at [http://www.bondmarkets.com/regulatory/SP\\_Addresses\\_NJ\\_Law.pdf](http://www.bondmarkets.com/regulatory/SP_Addresses_NJ_Law.pdf) (May 2, 2003).

312. See Press Release, Fitch Ratings, *supra* note 310; Press Release, Moody's Investors Service, Inc., *supra* note 310; Press Release, Standard and Poor's, *supra* note 310; see also Jonathan Fuerbringer, *Lending Law in New York Gets Different Interpretations*, N.Y. TIMES, Mar. 26, 2003, at C3.

313. See GA. BANKER'S ASS'N, GAFLA: THE UNINTENDED CONSEQUENCES 2 (2003), available at <http://www.gabankers.com/issuespredatorylendingwhitepaper.pdf> (Jan. 2003).

314. Press Release, Standard and Poor's, *supra* note 308.

315. S&P and Moody's both announced that they would rate all pools that do not contain high cost loans. Press Release, Standard & Poor's, Standard & Poor's Will Admit Georgia Mortgage Loans Into Rated Structured Finance Transactions (Mar. 11, 2003), available at <http://www.standardandpoors.com>; Press Release, Moody's Investors Service, Inc., Moody's To Rate RMBS Backed by Georgia Home Loans (Mar. 13, 2003), available at [http://www.moodys.com/moodys/cust/research/babylon/Release/Rating%20Action/noncategorized\\_number/2001900000420337.asp?namedEntity=Rating+Action](http://www.moodys.com/moodys/cust/research/babylon/Release/Rating%20Action/noncategorized_number/2001900000420337.asp?namedEntity=Rating+Action). Fitch announced that it would rate all residential mortgage pools, including those that contained high cost loans, if they also included additional credit enhancements. See Press Release, Fitch Ratings, Fitch Revises Its Rating Criteria in the Wake of Predatory Lending Legislation (May 1, 2003), available at [http://www.mortgagebankers.org/industry/reports/03/fitch\\_0501.htm](http://www.mortgagebankers.org/industry/reports/03/fitch_0501.htm).

316. Specifically, it announced that it would not rate pools that contain the following types of loans ("Excluded Loans"): High Cost Home Loans; Covered Home Loans; Home

several of the Act's damages provisions were unclear and therefore might expose assignees to unlimited liability. S&P's position threatened to destabilize the New Jersey mortgage market and motivated the lending industry in New Jersey to lobby for a significant dilution of HOSA's assignee liability provisions.<sup>317</sup> However, many of S&P's concerns were

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Loans made in connection with home improvements ("Home Improvement Loans"); Home Loans made in connection with manufactured homes ("Manufactured Housing Loans"); and open- and closed-end cash-out refinancing or junior lien mortgage loans. Press Release, Standard and Poor's, *supra* note 308.

S&P had excluded cash-out refinancings and junior lien loans "because the funds from these loans could be used for the purpose of home improvement (which loans carry the potential for assignee liability) and this fact may not be disclosed on origination." Press Release, Standard and Poor's, *supra* note 308. DOBI has taken the position that cash-out and junior lien mortgage loans are not subject to liability under sections 46:10B-27(b) or (c) of the Act "unless a home improvement contractor or manufactured home seller made the loan or was otherwise involved as specified" in section 46:10B-27(a). BULLETIN NO. 03-15, *supra* note 125, at 4. DOBI recommends that lenders "look at a range of factors related to an individual borrower's circumstances." *Id.* DOBI argues that the scope of section 46:10B-27(a) liability is based upon that imposed by the Federal Trade Commission's Holder in Due Course Rule. *Id.* The FTC Holder Rule requires some degree of involvement by the home improvement contractor or manufactured home seller for the FTC Holder Rule to become applicable to the transaction. BUREAU OF CONSUMER PROTECTION, GUIDELINES ON TRADE REGULATION RULE CONCERNING PRESERVATION OF CONSUMERS' CLAIMS AND DEFENSES 11,396-11,401 (1976); *see also* 16 C.F.R. § 433.2 (2003). The scope of section 46:10B-27 and that of the FTC Holder Rule do, indeed, overlap. And DOBI's interpretation of section 46:10B-27(a) is the most compelling. Nonetheless, it will be left up to the courts to decide whether the legislature intended for that section be interpreted similarly to the FTC Holder Rule.

In any case, DOBI notes that a purchaser of a loan will generally know whether a loan is a home improvement loan or manufactured home loan because the FTC Holder Rule requires that such a loan contains a prominent provision on the note itself that identifies the loan as a loan to which assignee liability may be attached. BULLETIN NO. 03-15, *supra* note 125, at 4. The FTC provision reads as follows:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

16 C.F.R. § 433.2.

This requirement, of course, would not protect the assignee who purchases from an originator who fails to comply with the FTC Holder Rule.

317. *S&P Surprises Lenders; Decision Not To Rate Certain Pools Cuts New Predatory Law Support*, BROKER, June/July 2003, at 30 (quoting E. Robert Levy, Executive Director, Mortgage Bankers Ass'n of New Jersey/League of Mortgage Lenders) ("We

unmerited. For example, S&P asserted, without clear explanation, that the Act creates unlimited liability for assignees of Covered Home Loans.<sup>318</sup> However, as previously explained, assignee liability for Covered Home Loans is specifically limited by the Act: (i) to suits brought in an individual capacity and (ii) for damages that cannot exceed the borrower's remaining obligation under the loan plus costs and reasonable attorney's fees.<sup>319</sup>

In contrast to S&P's initial position, Moody's and Fitch, the other major rating agencies quickly concluded that, despite some ambiguities in the Act's damages provisions, the risks to assignees are low enough that they will continue to rate New Jersey mortgage pools containing most types of Home Loans.<sup>320</sup> Moody's will generally not rate pools that contain more than 2% purchase money (that is, not refinanced) High Cost Home Loans or those that contain more than 5% refinanced Covered Home Loans.<sup>321</sup> Fitch will rate pools that contain Home Loans, Covered Home Loans, Home Loans made in connection with home improvements, and Home Loans made in connection with manufactured homes, but only so long as it receives certification by independent third parties that such pools do not contain any High Cost Home Loans.<sup>322</sup>

S&P has since come around to a position similar to Moody's and Fitch's position: it has now concluded that it will rate everything but High Cost Home Loans.<sup>323</sup> Fannie Mae and Freddie Mac, two of the largest purchasers

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obviously are not going to be able to live with the bill in the present form, unless S&P changes their position.”).

318. Press Release, Standard & Poor's, *supra* note 309.

319. See *supra* text accompanying notes 270-73.

320. Press Release, Moody's Investors Service, Inc., Moody's to Continue to Rate RMBS Backed by New Jersey Home Loans (Sept. 22, 2003); Press Release, Fitch Ratings, Fitch Ratings Responds to New Jersey Predatory Lending Legislation (June 5, 2003).

321. Press Release, Moody's Investors Service, Inc., *supra* note 310.

322. Press Release, Fitch Ratings, *supra* note 310.

323. Press Release, Standard & Poor's, Standard & Poor's Implements Credit Enhancement Criteria and Revises Representation and Warranty Criteria for Including Anti-Predatory Lending Law Loans in U.S. Rated Structured Finance Transactions 2 (May 13, 2004) (“Standard & Poor's is continuing to exclude the following loans from its rated pools: (i) High-Cost Home Loans, as defined in the New Jersey anti-predatory lending law . . . and (ii) loans governed by the Georgia Fair Lending Act prior to its amendment on March 7, 2003”), available at <http://www.mortgagebankers.org/industry/news/04/0518.html>. For all New Jersey Home Loans, S&P will impose certain due diligence requirements upon sellers “of structured finance transactions that include loans governed by” HOSA. *Id.* Moreover, in order to rate loan pools containing refinancings of New Jersey Covered Home Loans specifically, which S&P believes carries additional, subjective risk because of the “reasonable

of residential mortgages on the secondary market, have also stated that they will continue to purchase New Jersey Home Loans other than High Cost Home Loans.<sup>324</sup>

It is not surprising that the rating agencies have refused to rate mortgage pools containing High Cost Home Loans because of the significant potential liability they carry. If High Cost Home Loans are not given a bond rating, the secondary market will cease almost entirely to finance the origination of such loans. The assignee liability provisions of HOSA should therefore be considered the most powerful in the entire Act. Because, as previously described, a substantial proportion of borrowers that have been stuck with High Cost Home Loans could have qualified for better mortgage terms, the evaporation of High Cost Home Loans should not significantly reduce the availability of credit for subprime borrowers. Indeed, such borrowers may often be offered credit at a lower cost and with fairer terms.

## V. CONCLUSION

In the past decade, predatory lending has become one of the most significant threats to the realization of the American dream of home ownership for low- and moderate-income and African-American persons. One of the primary reasons predatory lending has been so elusive and devastating is that it has been difficult to define or regulate. Building upon the legislative efforts of the federal government and a small number of other states, the New Jersey Home Ownership Security Act implements an effective, balanced response that respects the complicated dynamic of the subprime residential mortgage market. Despite some ambiguities, the Act should accomplish much of its goal of curbing the worst abuses of predatory lending while preserving the availability of credit to all New Jersey consumers who need it.

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tangible net benefit" standard applied to this category of loans, S&P will require additional credit enhancements. *Id.* at 3.

324. FANNIE MAE, ANNOUNCEMENT 03-12: PURCHASE OF NEW JERSEY AND NEW MEXICO "HIGH-COST HOME LOANS," AND ILLINOIS "HIGH-RISK HOME LOANS" (2003), available at <http://www.mortgagebankers.org/resident/2003/fannie03-12.pdf> (Nov. 21, 2003); Letter from Michael C. May, Senior Vice President, Freddie Mac, to All Freddie Mac Sellers and Services, Revisions to Freddie Mac's Purchase Requirements based on the enactment of antipredatory lending legislation in New Jersey, New Mexico, Oklahoma, Illinois, Maine and Nevada (Nov. 26, 2003), available at [http://www.mortgagebankers.org/resident/2003/freddie\\_indyltr1126.pdf](http://www.mortgagebankers.org/resident/2003/freddie_indyltr1126.pdf).



