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BULLETIN NO. 03-15

TO: ALL INTERESTED PARTIES

FROM: H. ROBERT TILLMAN, ACTING COMMISSIONER AND DIRECTOR, DIVISION OF BANKING

RE: THE NEW JERSEY HOME OWNERSHIP SECURITY ACT OF 2002

The New Jersey Department of Banking and Insurance ("Department") is issuing this Bulletin in response to questions that have been raised about the New Jersey Home Ownership Security Act of 2002 (the "Act"), N.J.S.A. 46:10B-22 et seq., signed into law on May 1, 2003. The Act addresses abusive lending practices, and is designed specifically to prevent the issuance of those high-cost loans that are harmful to consumers. This Bulletin provides guidance about the operation and enforcement of the Act in response to the various questions and issues raised by interested parties. The Department will issue additional guidance and participate in compliance workshops in order to help the industry to prepare prior to the Act's effective date, November 27, 2003, as deemed necessary and appropriate. This Bulletin is for guidance purposes only and is not intended to constitute a discussion of all aspects of the Act.

LIMITATIONS ON DAMAGES

Question 1: An issue was raised as to whether the limits on damages and other provisions related to assignee liability (N.J.S.A. 46:10B-27) apply when an individual chooses to seek damages under the New Jersey Consumer Fraud Act ("CFA") as authorized under N.J.S.A. 46:10B-29a against an assignee or holder pursuant to the liability provisions in N.J.S.A. 46:10B-27 for a violation of the Act. The limits on damages apply to any assignee liability arising under N.J.S.A. 46:10B-27 and thus apply in this situation. N.J.S.A. 46:10B-27 sets forth specific terms and conditions under which assignees may be held liable under the Act, notwithstanding any other laws to the contrary. N.J.S.A. 46:10B-29a states that a borrower may seek damages for a violation of the Act pursuant to Section 7 of the CFA (N.J.S.A. 56:8-19), or may seek damages through N.J.S.A. 46:10B-29b. Regardless of which alternative in N.J.S.A. 46:10B-29 the borrower chooses, whenever a borrower seeks liability against an assignee or holder pursuant to N.J.S.A. 46:10B-27, the limits and conditions set forth for assignee liability in N.J.S.A. 46:10B-27 apply to such assignee liability.

Question 2: Another question was raised concerning whether a borrower can recover damages under both N.J.S.A 46:10B-27a and 27c from one assignee. In limited situations, yes. N.J.S.A. 46:10B-27a and 27c provide distinct remedies for different types of claims. Subject to the specified caps on damages and other limitations, section 27c allows a borrower to bring claims against an assignee that could be asserted against the original creditor. N.J.S.A. 46:10B-27a allows a borrower to bring claims against an assignee that could be asserted against the original seller of a manufactured home or home improvements, where the seller also had the requisite level of involvement in the loan transaction. In rare circumstances, therefore, a borrower may have multiple separate claims that can be brought under both N.J.S.A. 46:10B-27a and 27c simultaneously in connection with the same loan transaction. In that case, the damage caps would apply to the respective claim made under that subsection. The general principle that there can be no double recovery for the same loss would still apply.

<u>Question 3:</u> A question was raised concerning the cap on damages that may potentially be imposed against an assignee who purchases home improvement or manufactured housing loans pursuant to N.J.S.A. 46:10B-27a. The inquirer wanted to know what is included in the phrase "total amount paid by the borrower in connection with the transaction." This phrase is part of the explicit limitation on damages against assignees that a borrower may obtain pursuant to that subsection. N.J.S.A. 46:10B-27a represents a ceiling, not a minimum. This phrase includes items paid by the borrower to the original creditor, including principal and interest. However, because this phrase involves the interplay between existing Federal and State law, the Department is still examining the issue. Nonetheless, this language is based upon the FTC Holder Rule, 16 CFR §433, which has been the subject of substantial guidance by the FTC and the courts for almost 30 years. This rule provides that:

> "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 … Recovery hereunder by the debtor <u>shall not exceed amounts paid by the debtor</u> hereunder." (emphasis added).

The FTC Staff Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses (41 FR 20022 (May 14, 1976)) further states:

> "In other words, the consumer may assert, by way of claim or defense, a right not to pay all or part of the outstanding balance owed the creditor under the contract; but the consumer will not be entitled to receive from the creditor an affirmative recovery which exceeds the amounts of money the consumer has paid in."
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> Id. at 7.

CASHOUTS, JUNIOR LIENS, HOME IMPROVEMENT TYPE LOANS

Question 4: A question was also raised as to whether cash-out refinancing transactions and junior lien mortgage loans are subject to the provisions related to assignee liability for home improvement and manufactured housing loans under N.J.S.A. 46:10B-27. Cash-out and junior lien mortgage loans are not subject to this liability unless a home improvement contractor or manufactured home seller made the loan or was otherwise involved as specified in N.J.S.A. 46:10B-27a. This subsection provides that if a home improvement contractor or manufactured home seller arranges the loan, either directly or by means of a referral, the assignee or purchaser of such loans is subject to limited liability for any claims and defenses that a borrower may have against the seller or home-improvement contractor capped at a specified amount. The circumstances in which this provision apply are consistent with, and based upon, well-established law, most notably the Federal Trade Commission's Holder Rule promulgated in 1975. See 16 C.F.R. 433. See also the New Jersey Home Improvement Practices rules, N.J.A.C. 13:45A-16.2 et. seq. and the New Jersey Home Repair Financing Act, N.J.S.A. 17:16C-64.1 et.seq. Moreover, the provision requires the requisite degree of involvement by a home improvement contractor or a manufactured home seller. Thus, the provision does not apply to the situation when a borrower refinances his or her own home without the involvement of a home repair contractor, and subsequently uses cash obtained in the process to pay for home repairs and/or improvements.

Question 5: A question was also raised as to how much involvement a home improvement contractor or manufactured home seller must have in arranging the home loan for the assignee liability in N.J.S.A. 46:10B-27a to be applied. 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. See, e.g., the Staff Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses. 41 Fed. Reg. 20022 (May 14, 1976). For example, the circumstances in which a home improvement contractor will be determined to have "referred" a borrower to a lender under N.J.S.A. 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."

Question 6: A question was raised concerning how an assignee or purchaser would be able to determine whether a loan is a home improvement or manufactured home loan with the requisite degree of involvement by a home improvement contractor or a manufactured home seller such that the terms of N.J.S.A. 46:10B-27 apply. Based on existing law, a home improvement or manufactured home loan with the requisite degree of third party involvement is required to include a prominent provision on the note itself identifying it as a loan to which a limited degree of assignee liability is attached. Under the Federal Trade Commission's Holder Rule, it is an unfair and deceptive trade practice for a seller of goods and services to "take or receive a consumer credit contract", in this case a home loan, which fails to include a notice prescribed by the regulation regarding assignee liability. The rule also makes it an unfair and deceptive trade practice for a seller of goods and services to accept proceeds of a related loan where the seller referred the consumer to the creditor or is affiliated with the creditor, if the consumer credit contract fails to include a similar notice. 16 C.F.R. 433. New Jersey Home Improvement Practices Regulations mandate and similarly contain the federal mandate for such a prominent notice. See N.J.A.C. 13:45A-16.2(a)(13)(ii).

Assignees and purchasers should, therefore, be able to identify loans covered by N.J.S.A. 46:10B-27a in virtually all circumstances. It is possible, of course, that home improvement contractors and manufactured home sellers whose loans are covered by the FTC Holder Rule and the New Jersey Home Repair Financing Act may violate existing law and fail to include the requisite notice. With regard to this possibility, N.J.S.A. 46:10B-27a reinforces the obligations and measures that purchasers and assignees already take, or should take, to ensure that originators mandate compliance with existing federal and state law and do not ignore or inadvertently fail to follow the Holder Rule and state law requirements. See also Associates Home Equity Services, Inc. v. Beatrice Troup, 343 N.J. Super. 254, 778 A.2d 529 (2001) (when loan arranged by and in concert with home improvement contractor, lender cannot evade remedies available under the Holder Rule due to failure to include required notice provision). Assignees and purchasers have available mechanisms, including targeted inquiry prior to purchase, and representations and warranties as part of acquisition, to ensure loans being purchased or assigned are in compliance with federal and state law, including the requirements regarding notice under the FTC Holder Rule.

Question 7: A question was also raised concerning whether borrowers can assert class action claims under N.J.S.A. 46:10B-27a in connection with home improvement or manufactured home loans against creditors, assignees, or holders. N.J.S.A.46:10B-27a provides that the borrower may assert all affirmative claims against the creditor, any assignee or holder in any capacity. This provision does not restrict the ability of a borrower to raise class action claims. As a general matter, therefore, to the extent that a borrower has the ability to raise a claim by way of class action, this provision provides, subject to the limitation on damages set forth in the section, that a borrower may assert such claims in the same manner against an assignee or purchaser. This is consistent with existing rights and remedies under the FTC rules. The damages for each borrower in the class, however, will be limited to the amounts required to reduce or extinguish the borrower's liability under the loan, plus the total amount paid by the borrower in connection with the transaction, plus amounts required to recover costs, including reasonable attorney fees.

ESCROW PAYMENTS

Question 8: A question was also raised as to whether escrow payments for tax and insurance charges are included as "points and fees" and therefore used in determining whether a mortgage loan constitutes a "covered" loan or "high cost" loan as defined in the Act. Escrow payments for future payments of taxes and insurance are not included in the definition of "points and fees" under the Act. There may be confusion on this matter because the definition of "points and fees" includes "all items" listed in 15 U.S.C. 1605 (a)(1) through (4), with specified exceptions, and includes "all charges listed in 15 U.S.C. 1605(e)". It is noteworthy that the Act's reference to 15 U.S.C. 1605(e) in the definition of "points and fees" references "charges" rather than "items." Escrows for taxes and insurance are not "charges" and thus are not included in this portion of the Act's definition of "points and fees." It should also be noted that actual escrow charges (i.e. when a lender charges a fee for maintaining an escrow) and other specified items are only excluded from the definition of "points and fees" as long as the conditions of the exclusion are met. Under the Act, for an item or charge to be excluded from "points and fees" it must be "reasonable," must be "paid to a person other than a creditor or an affiliate of the creditor or to the mortgage broker or an affiliate of the mortgage broker," and must meet the conditions set forth in 12 C.F.R. 226.4(c)(7) and 12 C.F.R. 226.4(d)(2).

ASSIGNEE SAFE HARBOR DUE DILIGENCE

Question 9: Questions were also raised as to whether an entity exercising "due diligence," to prevent it from purchasing or taking assignment of any high-cost home loan pursuant to N.J.S.A. 46:10B-27b(3), must review 100% of loans being purchased in order to gain the safe harbor under N.J.S.A. 46:10B-27b(3). The Department will not require such a review. 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.

For example, to provide for quality control, secondary market participants, such as Fannie Mae, sample loan purchases to ensure conformance with general guidelines, including representations and warranties. This approach has been recommended in a recent advisory issued to give national banks guidance on "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans." In its advisory, the Office of the Comptroller of the Currency ("OCC") described recommended practices for mitigating the risk of purchasing predatory loans, suggesting that banks conduct quality control review of appropriate loan documentation at the beginning of a third-party relationship, when a particular problem had been identified, and periodically through random sampling as a key recommendation. The OCC stated that such sampling "should be adequate to ensure that loans are being underwritten consistently with the bank's policies. Loan reviews also should be sufficient to protect against potential fraud in these transactions." See OCC Advisory Letter, AL 2003-3 (February 21, 2003).

Accordingly, for the vast majority of mortgage pools, loan-by-loan file review is not necessary for meeting the "reasonable due diligence" requirement. In other contexts, courts have concluded "that the diligence conducted must be reasonable, not perfect." However, in some situations, such as when a pool is very small or an initial review has uncovered that the pool contains a number of high cost loans, then more extensive review may be required to meet the reasonableness requirement.

FLIPPING

Question 10: A question was raised whether the "flipping" restriction (also known as the "reasonable tangible net benefit" requirement) in N.J.S.A. 46:10B-25b applies to all home loans. Under the Act**,** the "flipping" restriction applies when two requirements are met. First, the new loan must meet the definition of a covered loan. The definition of a covered loan includes high cost loans. Second, the refinance must occur within 60 months of the closing of the prior home loan. It should also be noted that the Act does not provide a safe harbor presumption for any home loan or refinancing that is not a covered or high cost loan. These non-covered and non-high cost loans are still subject to rules regarding unconscionability as well as any unlawful practices under the CFA. A violation of the flipping provision in the Act, however, requires that the two (2) prerequisites set forth above are first met.

Question 11: Another question was raised as to what factors a lender should consider in determining compliance with the reasonable tangible net benefit standard related to a refinancing into a covered loan within 60 months from the prior home loan. A "reasonable, tangible net benefit" standard is inherently dependent on the totality of the facts and circumstances related to a specific transaction. While some loans may clearly provide a net benefit, others may require a closer review to determine whether a particular covered loan provides the requisite benefit to a borrower. In making this evaluation, lenders should look at a range of factors related to an individual borrower's circumstances. Examples of factors that could be relevant include, but are not limited to, the following:

- 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.

While the Department will not mandate that lenders use a prescribed form for evaluating the economic or non-economic benefits of a particular covered loan, lenders are encouraged to maintain records in the loan file to demonstrate that they conducted an analysis of this standard in each covered refinancing transaction. It is the lender's responsibility to ensure that a borrower received a tangible net benefit, and an appropriate analysis reflected in documentation can be helpful in making sure that a lender satisfies that responsibility. As part of a lender's analysis, a lender may wish to obtain an explanation from the borrower regarding any non-economic benefits the borrower associates with the loan transaction.

Any questions about this Bulletin or the Act may be directed to the Director of the Division of Banking, Department of Banking and Insurance, 20 West State Street, P. O. Box 040, Trenton, New Jersey 08625-0040.

7/25/03
Date

/s/ H. Robert Tillman
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