

HOW TO USE THIS MANUAL

Pratt's State Regulation of Second Mortgage and Home Equity Loans identifies and explains the state laws and regulations that affect making and brokering junior (commonly and collectively called second) mortgage loans and home equity lines of credit. Two significant developments, one in the marketplace and the other in the legal/regulatory environment, created the need for this work.

First, mortgage bankers, commercial banks, thrifts, and consumer finance companies have increased their home equity lending dramatically in the last 10 years. This has resulted from at least two factors: the elimination of the tax deduction for interest paid on consumer-type loans with the continued deductibility of home mortgage interest; and the aging of the "baby boomer" generation which is reaching its peak earning years at the same time that it has accumulated savings in the form of home equity.

Despite the recent growth of the market, in 1995 it was estimated that home equity debt in the United States was less than \$30 billion, or less than 8 percent of the existing equity in residential property. Seeing a growth opportunity, mortgage bankers, banks, thrifts, and others are rapidly expanding their offerings in home equity loans and second mortgages. Not only are there more loans outstanding, but the balances on existing loans have increased by about 50 percent in the years between 1988 and 1995. Thus, there are more loans, and there is more money being loaned.

Second, government agencies have taken an active approach toward regulating mortgage lenders and the residential loan industry, particularly since 1975. By 1985, two-thirds of the states had adopted laws regulating lenders of residential mortgage loans, and as of 1996, less than a handful of states did not regulate the industry. In 1996 alone, two states and the District of Columbia adopted residential mortgage laws to license and govern the conduct of mortgage lenders and mortgage loan brokers.

Despite increased government involvement, the states have not been uniform in their approach to regulating second mortgage lenders. In about half the states, there is no distinction in the mortgage banker law between residential first mortgages and mortgages secured by subordinate liens — the same law covers both. However, about a dozen states have adopted versions of the Uniform Consumer Credit Code, which can be applicable to second mortgage loans depending on the size of the loan, the interest rate, the identity of the borrower, and the loan's purpose. Finally, fewer than a dozen states have particular laws expressly dealing with second mortgages. A lender participating in this segment of the market must evaluate carefully which of these laws applies to its activities; in many cases, more than one body of state law will apply.

Second mortgage loans are typically available as either closed-end loans in which the loan principal is advanced to the borrower in a lump sum at loan closing, or as open-end home equity lines of credit, in which the borrower is granted a credit line with a maximum principal balance, which he or she accesses through the use of special checks or other devices. According to data from SMR Research, in 1984 closed-end second mortgages accounted for the vast majority of subordinate

lien loans, while home equity lines accounted for only 20 percent. Ten years later, the two types of loans accounted for a roughly equivalent market share.

Banks continue to have the largest market share of home equity lines (58 percent), with mortgage companies and finance companies active participants as well. The borrowers of such loans are generally believed to be members of high-income households who use the funds for luxury and lifestyle purchases as well as more basic household needs. Home improvement is also a strong motivation for taking a second mortgage.

In addition, the subprime or so-called "B and C" paper market for lower quality credit borrowers has grown rapidly in recent years as conforming lenders seek new opportunities for lending. Second mortgage products and equity-based lending comprise a significant share of this segment of the industry, with high-potential profitability.

The combination of varied lenders, an attractive demographic group of borrowers, opportunities for entry into new markets and enhanced profits from loan products, as well as an increasingly active state regulatory environment, created the need for a comprehensive work on the state regulation of the second mortgage/home equity loan industry. *Pratt's State Regulation of Second Mortgage and Home Equity Loans* attempts to fill this need.

The manual is organized into six regional binders:

- **Northeast:** Connecticut, Maine, Massachusetts, New Hampshire, New York, Rhode Island, Vermont
- **Mid-Atlantic:** Delaware, District of Columbia, Maryland, New Jersey, Pennsylvania, Virginia
- **Southeast:** Alabama, Florida, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, Tennessee, West Virginia
- **South Central:** Arizona, Arkansas, Colorado, Kansas, Louisiana, Missouri, New Mexico, Oklahoma, Texas
- **North Central:** Illinois, Indiana, Iowa, Michigan, Minnesota, Nebraska, North Dakota, Ohio, South Dakota, Wisconsin
- **Western:** Alaska, California, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, Wyoming

Each chapter deals with one state and contains identical topic entries to make it easier for you to find specific information. In addition, chapters contain state-specific forms, regulations, and other official documents for you to copy and use.

Recognizing that the regulatory environment for second mortgage and home equity lenders will continue to develop and change, the authors of *Pratt's State Regulation of Second Mortgage*

and Home Equity Loans will update the chapters periodically, and welcome suggestions for new topics as well as input from readers.

For some states we have provided pre-publication update summaries to alert you to very recent activity related to second mortgages and home equity loans in those states. This information will be incorporated and revised as necessary in future updates.

FEDERAL PREEMPTION OF STATE LAWS ON HOME EQUITY LOANS AND SECOND MORTGAGES

Lenders making second mortgage loans and home equity loans should be mindful of the effects of federal preemption of state laws. This guide, which is primarily designed to detail state laws, does not attempt to make determinations on the effect of federal preemption with respect to particular loans or lenders.

Federal law regulates some of the same lending activities that are addressed by state law. Some lenders are subject to federal, rather than state, regulation by virtue of their status as federally chartered institutions. A lender that is a federally chartered or federally regulated institution is frequently exempt from state laws on licensing or registration as a mortgage lender. However, these institutions may nevertheless be subject to other substantive provisions of state law concerning their conduct in making loans.

The type of loan may also be relevant in determining whether state or federal law governs. For certain alternative mortgage transactions (e.g., adjustable rate loans, graduated payment or shared appreciation loans, balloon payment and negative amortization loans), federal law governs to the extent the lender is a housing creditor within the meaning of federal regulations on alternative mortgages and follows federal rules for the making of such loans. If a qualified housing creditor does not follow federal rules, it will be subject to state laws on these types of loans. Even if it does follow the federal rules, several other provisions of state law will still apply. It is this body of state law that is discussed in the individual state chapters of this manual.

Adding a further wrinkle to the issue of federal preemption, several of the federal laws on mortgage regulation, when enacted, contained an “opt-out” provision, allowing states to nullify the effect of federal preemption and reestablish state law as the governing law. Under the Alternative Mortgage Transaction Parity Act of 1982, 12 USC §3801 *et seq.*, for example, five states acted within the allowable window period to override the federal preemption of state law on alternative mortgages: Maine, Massachusetts, New York, South Carolina, and Wisconsin. Thus, in these states, the entire body of state law, rather than federal law, governs the making of such loans.

Particular provisions of state law may be unenforceable to the extent they conflict with or contradict federal law on a particular subject. For example, a federally insured loan made under the provisions of the National Housing Act by an Federal Housing Administration (FHA) lender is subject to FHA guidelines on matters such as late charges; the allowable charges for an FHA loan may differ or be less than the allowable late charge under state law. In this case, the federal rule governs for an FHA loan.

Second mortgage loans and home equity lines of credit are subject to substantial regulation under the federal Truth-in-Lending Act (TILA), 15 USC §1601 *et seq.*, and its implementing

Regulation Z, 12 CFR 226, with regard to advertising and disclosures, and limitations on the terms of such loans, in all states that have not been exempted from portions of TILA based on enactment of a state law that is substantially similar to federal law with provision for adequate state enforcement.¹ These federal rules preempt state laws on a lender's ability to change loan terms and terminate loan agreements and include the required content of open-end credit billing rights notices, among other things. Lenders should pay particular attention to the coverage of TILA when developing open-end home equity loan products. The Real Estate Settlement Procedures Act (RESPA), 12 USC §2601 *et seq.*, and its implementing Regulation X, 24 CFR 3500, also apply to most junior lien and home equity loans.

In fact, it is a common provision in state law that compliance with some aspect of federal law, typically TILA or RESPA, constitutes compliance with similar requirements of state law. Thus, to the extent that a lender complies with federal law, it will satisfy selected state law requirements in many states.

A lender must evaluate its particular lending authority based on its form of organization and authorizing agency, the type of loan to be made; and whether that loan is governed by federal rules or guidelines (for example, FHA, Veterans Administration (VA) or adjustable rate loans); and the legal effect of state laws in light of federal laws on the same subjects in order to determine whether state or federal law applies.

1. The following states have been granted partial exemption from TILA: Maine (credit transactions subject to the Maine Consumer Credit Code); Connecticut (transactions subject to the Connecticut Truth-in-Lending Act); Massachusetts (transactions subject to the Massachusetts Truth-in-Lending Act); Oklahoma (credit transactions subject to the Oklahoma Consumer Credit Code); and Wyoming (credit transactions subject to the Wyoming Consumer Credit Code).