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Management Alert

New Massachusetts Regulations On Mortgage Lending Create Potential Risks for Brokers and Lenders

Reacting to the sharp rise in mortgage foreclosures, the Massachusetts Attorney General recently revised Massachusetts' mortgage industry regulations, which will go into effect on November 15, 2007.[1] In summary, the new regulations will change the playing field in the following key ways:

- *Purchase money and new construction mortgages are now covered by the regulations;*
- *Brokers must consider whether the borrower could pay for a loan under a "worst case" scenario;*
- *No-documentation loans now require more documentation, disclosures, and care, from both the borrow and lender;*
- *Brokers are subject to a new high degree of responsibility in that they have to keep the borrower's "best interests" in mind; and*
- *Lenders may only consider so-called "bona fide" criteria in making loans.*

The new regulations were promulgated under authority of the Consumer and Business Protection Act, known as Chapter 93A. Although similar in most respects, the scope of the regulations is broader than that of the prior regulations, which were themselves adopted in 1992 in response to the previous significant crisis in the mortgage industry. The regulations are similar in that only residential mortgages, not commercial loans, are covered, the regulations do not apply to reverse mortgages or open-ended home equity lines of credit, and subsidized/low-income mortgages administered by municipalities remain excluded as before. The regulations are broader, however, in that they now apply to purchase money and new construction mortgages. As before, the regulations apply to all companies doing business in Massachusetts.

In addition to expanding the scope of the regulations, the Attorney General has made four substantive additions to the 1992 regulations.[2] These four new additions have been added as subsections under § 8.06, and raise new and increased duties and responsibilities for both brokers and lenders.[3]

A. 8.06(15)

Newly-added subsection (15) requires that brokers now consider several non-exclusive factors in deciding whether to make or process a loan, based on what they know at the time of the loan. Critically, these factors include reasonably evaluating the borrower's ability to pay the

1 Disclosure provisions go into effect January 2, 2008.

2 The new regulations also have added two procedural requirements regarding the use of new loan forms and loan form language.

3 This discussion does not consider preemption issues related to the Federal Banking Act, which should be discussed with appropriate legal counsel.

loan “at the maximum rates or payments that may adjust upward” as well as their ability to pay under potential upwards adjustments of the borrower’s property taxes and insurance costs.

This new section not only will require brokers and lenders to evaluate a borrower’s ability to repay at the highest possible interest rate, but also, in effect, to predict the levels of potential real estate appreciation and rising insurance costs. This requirement leaves unanswered a number of questions about what is “reasonable” under these regulations. Indeed, many economists and other experts cannot predict what the real estate market will do, but these new regulations appear to require that mortgage brokers and lenders do just that—*i.e.,* evaluate whether a given loan is reasonable based on future potential movement of the real estate market.

B. 8.06(16)

Subsection (16) imposes new restrictions on no-income-verification loans or “no documentation” loans. Under this subsection, mortgage brokers and lenders will no longer be able to issue no documentation loans unless they obtain a signed disclosure form that discloses the borrower’s income and the source of that income in detail, as well as disclosing to the borrower whether such a “no documentation” loan provides less favorable terms than one with documentation. Stated simply, under this new section, “no documentation” loans now will effectively mean “some documentation” loans.

In addition, subsection (16) will also prohibit closing a loan when the amount of the income stated is not reasonable for the actual employment status or experience of the borrower, or when the borrower’s stated employment or stated income is not reasonable in light of the borrower’s circumstances (both as known to the lender). In other words, if the lender has facts that suggest that it is unreasonable to believe the borrower’s income statement, they cannot make the loan. Once again, no guidance is offered on what “reasonable” means in this context, whether “known to the lender,” means being on “actual” or “inquiry” notice, or whether it requires “actual” or “constructive” knowledge.

C. 8.06(17)

Perhaps the most significant change is in subsection (17), which defines as an unfair or deceptive practice the act of a mortgage broker in making, processing or arranging a loan that is “not in the borrower’s best interests.” Subsection (17) also enumerates two other new requirements: First, it requires full disclosure of financial conflicts of interest for the broker (*e.g.,* where the broker’s compensation is increased if the borrower takes a higher interest loan); and, second, it forbids any disclaimers of the new duties under this section by the mortgage broker.

Again, the most significant question raised by this new section is: what is the standard to be applied, or how does a broker determine what is a borrower’s “best interest”? Does this standard remain at the traditional “arms-length” negotiation standard or does it approach something like a fiduciary duty? Fiduciary duties are the highest form of duty in that they require the interests of the client to be placed above those of the fiduciary. If this new duty is a fiduciary duty, it would be unprecedented. Previously, lending relationships have always been considered “arms-length” transactions and not fiduciary ones (in the absence of a special relationship). *See, e.g., McIntyre v. Okurowski,* 717 F. Supp. 10, 11 (D. Mass. 1989).

The Attorney General may be prevailed upon to clarify the standard under subsection (17), but until that time, potential mortgage broker liability will become a lot more complex and uncertain.

D. 8.06(18)

Although it does not expressly state this, subsection (18) is probably an attempt by the Attorney General to combat discriminatory lending practices. By its terms, it prohibits lenders from using pricing models that take treat borrowers with similar credit criteria and bona fide qualification criteria differently.

This subsection appears to overlap other Massachusetts law, including Mass. Gen. L. ch. 151B, which provides the sole remedy for discriminatory conduct. The Attorney General will either need to clarify the potential conflict between the new regulations and § 151B, or litigation and the courts will need to do so as cases move through the system. That consideration aside, however, until such time as that issue is clarified, lenders will need to be diligent to ensure that their underwriting practices expressly rely on credit and other bona fide factors (which are defined in the regulations, in a non-exclusive list, as "income, assets, credit history, credit score, income-to-debt ratios or loan to value ratios").

If you have any questions regarding this Management Alert, please contact the Seyfarth Shaw LLP attorney with whom you work, or any Corporate attorney on our website, www.seyfarth.com.

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