INDEPENDENT BANKERS ASSOCIATION OF TEXAS
TESTIMONY TO
SENATE BUSINESS & COMMERCE COMMITTEE
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The Independent Bankers Association of Texas ("IBAT") is a trade association representing over 2000 community banks and branch locations in the state of Texas. Residential mortgage lending is a very significant activity for virtually all of its members. These community banks may provide loans by acting as a broker for other lenders, making loans to sell in the secondary market, or making loans to retain in their own portfolio. Often the mortgage loans in rural or small town markets do not meet the stringent criteria for the secondary market (Fannie Mae or Freddie Mac). The loans that are retained are typically serviced by the originating bank. The loan payments for these transactions may include escrow for taxes and insurance. Under Title XIV of the Dodd-Frank Act as well as recent changes to Regulation Z (Truth in Lending), there is likely to be a significant increase in escrowing for taxes and insurance on such loans. (Even if customers do not want to escrow and even if the bank does not want to escrow, the legal framework will require escrows for a minimum five years in certain cases.)

The purpose of this written testimony is to very briefly describe the federal and state legal framework that currently exists with regard to servicing of mortgage loans.

Real Estate Settlement Procedures Act (RESPA). The most comprehensive set of rules relating to servicing of mortgage loans is found in RESPA. (See 24 CFR 3500.21—Mortgage servicing transfers.) When consumers apply for residential mortgage loans, they must receive a disclosure that explains whether the loan may be assigned, sold or transferred and the likelihood of this event. If the servicing is in fact transferred, the consumer must receive specified notices of this fact with contact information. Further, the consumer has the right to make a "qualified written request" to the servicer requesting detailed information about their payment history if they believe that there have been errors. Failure of the servicer to comply with this section can result in an award of actual damages plus statutory punitive damages. Class action suits are authorized.

RESPA also has very comprehensive rules regarding escrow accounts (see 24 CFR 3500.17). Among other requirements, this section limits the amount of cushion that can be required for the escrow account to two months. The escrow account must be reviewed every year and reconciled so as to deal with shortages and surpluses. Consumers receive specified disclosures at closing and in an annual escrow account statement. The servicer must make payments out of escrow to the taxing authorities and insurance carriers in a timely manner to avoid penalties. Noncompliance is subject to civil money penalties imposed by HUD. Banking regulators review for RESPA compliance in exams.

Truth in Lending (Regulation Z). Recent amendments to Regulation Z require a "transfer" notice to consumers when their residential mortgage loan is transferred to a different owner. This is different from the servicing transfer and is intended to assure that the consumer will know who actually owns their note.

Other provisions in Regulation Z (12 CFR 226.35) require a creditor to escrow for taxes and insurance for at least one year if the mortgage loan is a "higher priced mortgage loan" secured by the consumer's principal dwelling. This is defined as a first lien transaction whose interest

rate exceeds the "average prime offer rate" by 1.5%; second lien whose rate exceeds the APOR by 3.5%. The "average prime offer rate" is calculated by the Fed and is based on loans to consumers with low risk pricing characteristics. Currently, this calculation would make a typical mortgage loan at 6% a higher priced one!

Texas Finance Code. Although state laws regulating the interest rate on first lien residential mortgages is preempted by federal law, the Texas Finance Code still provides some clarifications. For example, Section 302.102 prohibits prepayment penalties on mortgage loans with an interest rate greater than 12%. Late charges are not regulated on first lien transactions. However, there are specific authorizations (and limits) on late fees in other situations. Section 302.001(d) authorizes a late fee of the greater of $7.50 or 5% of the payment after 10 days delinquency on loans with a rate of 10% or less. Sections 342.302 and 342.303 provide for a late fee on secondary mortgage loans (with a rate over 10%) that are delinquent 10 days or more. Again, 5% of the payment is permitted on a simple interest or regular transaction. Charging a fee when it is not authorized or in excess of the amount authorized would violate these usury laws of Texas and would trigger statutory penalties.

Chapter 343 of the Texas Finance Code relates to home loans and has additional requirements and limitations relating to "high-cost" loans (using the definition found in Regulation Z, 12 CFR 226.32). For example, prepayment penalties are prohibited for such loans (343.205). Also, lenders may not charge a borrower for a service or product if the borrower does not receive the service or product (343.206).

Collateral Protection Insurance. The Texas Finance Code, Chapter 307, provides a complete framework for collateral protection insurance on any secured transaction, including mortgage loans. This chapter requires disclosures at various points in the credit transaction, including clear contractual language relating to the requirement to maintain insurance on the property. Borrowers may use existing policies, purchase policies through the creditor if desired, or finance the insurance. However, if they do not maintain the insurance, then the creditor is required to send a series of notices to the borrower reminding the borrower of the default and giving them an opportunity to provide proof of coverage. If this proof is not provided, then the creditor may "force place" insurance that either covers the creditor only (unless the collateral is a manufactured home) or covers both the creditor and the borrower.

Title XIV of the Dodd-Frank Act also has explicit requirements regarding collateral protection insurance on residential mortgages. Although these new federal provisions are subject to rule-making, they are very similar to existing state law.

Insurance: Disposition of Proceeds. The Texas Insurance Code, chapter 557, deals extensively with the procedures to be followed by a lender pending repair of residential real property. This chapter requires certain notices from the lender to the insured/borrower about the release of insurance claim proceeds. Furthermore, it spells out the rules for endorsement of claim checks by the lender along with penalties for failure to comply with the law.

Property Taxes. The Texas Constitution, Article 8, Section 1-b, and Section 11.13 of the Texas Tax Code provide certain exemptions on residential homestead with regard to property taxes. In addition, taxpayers aged 65 or older or disabled homeowners have certain deferral rights. However, if taxes are deferred, a superior lien is created against the property. This impairs the creditor's collateral and is an event of default under a typical deed of trust.

The Comptroller of Public Accounts and county tax assessors have an array of educational materials that are available online or are sent with the annual property assessment of value, giving the homeowner information on how to claim their exemptions, if any. Assessment notices are provided to the actual owner of the property every year even if the creditor/servicer is actually paying the taxes. Creditors are not required to apply for exemptions for homeowners. Furthermore, with the abundant information available to the homeowner, they should not be required to do so. The cost of obtaining and then tracking the birthdays of the owners would significantly increase the cost of servicing.

Adjustable Rate Mortgages. These loans have rates based on an index plus a margin. Initially the interest rate on such a transaction is apt to be lower than that for a fixed rate loan. However, the adjustment allows the creditor to match the rate to cost of funds and to comply with bank regulatory expectations relating to asset/liability matching.

Regulation Z has extensive requirements—both at application, closing, and periodically—with regard to ARMs. These include a special informative booklet about ARMs from the Fed, an explanation of the creditor’s programs along with historical examples, and then notices of rate changes no less than 25 days before a change that results in a payment change. Even if there is no payment change, the consumer must receive an annual notice of rate change. There must be a cap on the rate, although that cap could be the usury ceiling.

Balloon Notes. ARMs require significantly more data processing and management than a fixed rate mortgage. Therefore, some community banks offer fixed rate loans that amortize on a lengthy period but have a balloon payment so that the bank can adjust the interest rate. Typically the payments may be based on a thirty year amortization schedule but balloon at five or seven years. Again, Title XIV of Dodd-Frank Act will likely limit the availability of this product to some extent, except in rural markets. Also, balloon notes are restricted by Regulation Z, Section 226.32(d)(1) and Section 343.202 Texas Finance Code.

Loan Modifications. Several federal programs have been put in place to deal with residential mortgage modifications. Most of these are extremely rigid and paperwork intensive. Furthermore, the federal regulators have learned that the majority of consumers with loans modified under these programs have re-defaulted.

Many community bankers have instead offered simple modifications of mortgages in order to assure that stressed borrowers can continue to make their payments. There are pending changes to Regulation Z that would affect the disclosure of such modifications. At this time, the process is fairly simple and usually includes the filing of a one-page “renewal and extension” agreement in the real property records.

Conclusions. Community banks are a vital part of the residential mortgage scene. Their activities in making and then servicing such loans are highly regulated under state and federal laws and regulations and will become even more regulated under the Dodd-Frank Act. In addition, to the areas already discussed and identified, that Act will give the new Bureau for Consumer Financial Protection the authority to regulate “unfair, deceptive or abusive acts or practices.” The Bureau has authority to regulate an array of financial institutions, including mortgage servicers. Accordingly, IBAT believes that the existing framework is more than adequate to protect consumers and will become even more rigorous in the near future.

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