Beware Unique Compliance Risks In Home Equity Lending

By **Heidi Bauer, Steve vonBerg and Graham Gardner** (August 18, 2023)

As borrowers increasingly look to junior-lien mortgages and home equity lines of credit, or HELOCs, instead of first-lien mortgages, many lenders are predictably rushing to satisfy this newfound demand in the market.

Heidi Bauer

Unfortunately, the regulatory structure for these competing mortgage products can vary widely across the country, and significant risks are present for the unwary lender who does not perform proper due diligence before venturing into new loan product offerings.

This article explores the types of differences in regulations we have seen recently as we have walked clients through the pathway to offering new loan products to meet borrower demands.

Steve vonBerg

Over the past two years, mortgage interest rates have steadily climbed, with average 30-year fixed rates rising from a low of 2.65% in January 2021, to 6.96% in July 2023, the highest since April 2002 — except for a brief climb to 7.08% in October and November of last year.[1]

As a result of these rate increases, first-lien mortgage originations are down across the industry. Data from the Federal Reserve Board shows that mortgage balances rose modestly by $121 billion in the first quarter of 2023,[2] compared to a rise of $250 billion in the first quarter of 2022.[3]

Graham Gardner

In contrast, balances on HELOCs have increased for four consecutive quarters following almost 13 years of declining balances.[4]

Because borrowers are loath to part with the rock-bottom rates that they locked in on their mortgages during the refinance boom a couple of years ago, many consumers are turning instead to junior-lien mortgages and HELOCs as an alternative way to tap into the equity in their homes, with lenders especially eager to meet this growing demand given the decline in the purchase money market.

Although mortgage lenders may be tempted to treat these junior-lien products the same way they treat first-lien products, the rules and regulations on closed-end second mortgages and HELOCs are substantially different than those governing first mortgages.

As a result, there are many legal and regulatory pitfalls that lenders may find themselves in if they are not careful — just as regulators are turning their attention to these freshly popular credit products.

First, there may be several additional licensing requirements that lenders need to satisfy before offering junior-lien mortgage products to consumers.

For example, Michigan has separate statutory licensing regimes for first and second

mortgage lending, with different licenses required for each activity.[5] A lender who begins making second-lien mortgages, including HELOCs, before obtaining the proper licensure may find themselves in violation of state licensing statutes and put their existing licenses at risk.

In addition, licensed lenders should notify their state licensing regulators of the impending expansion into the subordinate lien market and update the business activities section of their Nationwide Multistate Licensing System account accordingly.

Second, interest rate caps that do not apply to first-lien mortgages may apply to junior-lien mortgage products in various states.

This is because the Depository Institutions Deregulation and Monetary Control Act provides that first-lien, federally related residential mortgage loans are exempt from state laws that expressly limit the interest rate or finance charges that can be applied, but does not apply to junior-lien loans.[6]

Accordingly, junior-lien mortgage and HELOCs may be subject to interest rate and finance charge restrictions that are otherwise inapplicable to first-lien mortgage products.[7]

Finally, there are additional disclosure requirements and practice restrictions at the state level that can take many forms.

One such restriction on closed-end second-lien mortgages that we have seen in several states is a restriction on balloon payments.

For example, in Utah, a consumer has the right to refinance the amount of any payment due that is more than twice as large as the average of the previous payments, and the lender must offer terms no less favorable than those currently being offered to the general public for the same type of credit.[8] This provision does not apply to closed-end first lien mortgage loans, but does apply to second-lien mortgages.[9]

Similarly, Wisconsin prohibits entering into an agreement that requires a schedule of payments under which any one payment is not substantially equal to the other payments in most circumstances.[10] Similar to the Utah provision, this Wisconsin provision does not apply to first-lien mortgages, but otherwise applies to second-lien mortgages where the loan amount exceeds $25,000.[11]

A second restriction is that HELOCs, as open-end credit, often involve very different disclosure requirements than first-lien mortgages.

For example, New Hampshire has disclosure requirements specific to open-end credit extensions like HELOCs. These include disclosures related to the interest rate, expressed in both annual and daily rates, maximum amount of credit, information related to the method used to compute monthly payments, repayment periods and relevant monthly due dates.[12]

Before offering open-end credit products like a HELOC to consumers, it is important to review all disclosure requirements and practice restrictions that may apply to such products.

Because of the unique requirements and restrictions that accompany alternative loan products to first-lien mortgages such as second-lien mortgages and HELOCs across the country, there are significant pitfalls and regulatory risk that can accompany a lender's

decision to enter these markets during this period of consumer demand shift.

As these alternative products become more popular, regulators are sure to begin paying them increased attention and these products likely will become an increased focus during state examinations.

It is of the utmost importance that before beginning to offer additional consumer credit products, you familiarize yourself with the unique requirements, restrictions and risks that accompany those products.

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[1] Federal Reserve Bank of St. Louis, 30-Year Fixed Mortgage Average in the United States, July 13, 2023, https://fred.stlouisfed.org/series/MORTGAGE30US#0.

[2] Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit, May 2023 ("New York Fed Q1 2023 Report"), https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2023Q1.

[3] Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit, May 2022, https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2022Q1

[4] New York Fed Q1 2023 Report.

[5] Mich. Comp. Laws Ann. §§ 445.1652; 493.52.

[6] 12 U.S.C. § 1735f-7. Some states opted out of this preemption provision according to the terms of 12 U.S.C. § 1735f-7a(b).

[7] See, e.g., Va. Code Ann. §§ 6.2-327(B), 6.2-312(F).

[8] Utah Code Ann. § 70C-3-102.

[9] Utah Code Ann. § 70C-1-202(2).

[10] Wis. Stat. Ann. § 422.402(1).

[11] Wis. Stat. Ann. § 421.202.

[12] N.H. Rev. Stat. Ann. § 397-A:15(VI).