BANKING
DEPARTMENT OF BANKING AND INSURANCE
DIVISION OF BANKING

Licensed Lenders: Mortgage Bankers; Correspondent Mortgage Bankers; Mortgage Brokers; Secondary Lenders; Consumer Lenders and Sales Finance Companies

First Mortgage Loans

Adopted Amendment: N.J.A.C. 3:15-10.4

Proposed: December 20, 2004 at 36 N.J.R. 5604(a).

Adopted: December 19, 2005 by Donald Bryan, Acting Commissioner, Department of Banking and Insurance.

Filed: December 19, 2005 as R. 2005 d.35, **without change**.

Authority: N.J.S.A. 17:1-8.1, 17:1-5e and 17:11C-1.

Effective Date: January 17, 2006

Expiration Date: October 10, 2007

Summary of Public Comments and Agency Responses:

The Department of Banking and Insurance (Department) received written comments from Dennis Casale, Esq. of the Law Firm of Pepper Hamilton, LLP and David McMillin, Senior Attorney, Legal Services of New Jersey, Inc.

COMMENT: The commenter stated that he supported the proposed rule amendment.

RESPONSE: The Department appreciates the expression of support for the proposal.

COMMENT: One commenter stated that he was glad to see that the current regulations, which could be read to prohibit borrowers from pledging financial assets as additional collateral, and are overly broad, are proposed to be amended. The commenter noted that national lenders offer

programs that permit borrowers to pledge securities and other financial assets as additional security and that the programs are popular and beneficial for qualified borrowers. The commenter supports the amendment, which makes it clear that such programs continue to be permissible in New Jersey.

RESPONSE: The Department agrees with the commenter that, on a public policy basis, the prior language was overly broad. It did not accurately reflect the intention of the Department.

COMMENT: One commenter stated that the proposed rule amendment is a substantial rollback of consumer protections that have been in place for two years. The commenter stated that the addition of N.J.A.C. 3:15-10.4 in 2002, which prevented lenders from taking extraneous security interests in mortgage lending, was a positive step providing significant protections to consumers. The commenter urged the Department not to adopt the current proposal but to draft rules permitting lenders to make only certain suitable purchase-money pledged asset loans and not to promulgate a rule that would permit much broader and potentially predatory practices.

RESPONSE: The Department is sensitive to the commenter's concerns. For that reason, the Department listed specific items to be prohibited as collateral in the proposal. Beyond those items, the Department wishes to allow flexibility in financial arrangements. Therefore, the Department declines the commenter's suggestion to refrain from adopting the current proposal and create a two-track system where pledged asset loans would only be permitted for purchase money mortgage transactions.

COMMENT: One commenter stated that certain risky purchase money mortgage loans that allow well-off home purchasers to avoid selling securities or terminating certificates of deposit in

order to raise cash for down payments have been available for a number of years, and are known as "pledged asset mortgages, asset-integrated mortgages or 100 percent mortgages." The commenter noted that business writers have warned the public that these loans can put the borrower's home at risk because, if the value of the securities declines, additional assets must be added or the lender can foreclose. The commenter also noted that the National Association of Securities Dealers issued an alert that 100 percent mortgages are not suitable for everyone and that many investors may not be aware of all of the risks and do not understand that securities pledged in lieu of a down payment may be liquidated if the value of the securities drops below a certain level or there is a default in the mortgage. The commenter stated that, although these risks currently only affect a small segment of the market, they believe that opening this market to licensed lenders is unnecessary and would lead to over-leveraging of vulnerable buyers.

RESPONSE: The Department believes that buyers who have sufficient securities to pledge are likely to have some sophistication in financial matters and to, therefore, appreciate the risk of a decline in the value of pledged securities. The Department believes the benefits inherent in allowing greater consumer choice outweigh the risks in this case.

COMMENT: One commenter stated that the Department should continue to prohibit pledged asset mortgages in the context of non-purchase money mortgages. The commenter stated that pledged asset mortgages are currently being offered by bank lenders and are marketed as an alternative to down payments at purchase for borrowers who have substantial assets that they prefer not to liquidate, even if that exposes them to some risk. Another advantage identified is that they permit home purchasers with illiquid assets to avoid the cost of private mortgage insurance, typically required when the initial down payment is less than 20 percent of the fair

market value of the property. The commenter stated that these advantages are unique to purchase money loans. The commenter stated that on the other side of the coin, senior citizens and others on fixed incomes who may have a modest nest egg, whether in stocks or securities or in a deposit account, may be encouraged or enticed into granting a security interest in these assets in order to make a home equity loan more attractive to a lender or secondary mortgage purchaser or to increase the principal amount of the loan. The commenter stated, however, that this step would be taken at a considerable risk to the borrower's nest egg and to their home. The commenter went on to note that the risk of the nest egg no longer being available in case of an unanticipated financial crisis could result in the foreclosure of the home. Further, the risk of loss of value in pledged securities poses a risk to someone without substantial assets.

RESPONSE: The Department acknowledges that the commenter's observations have merit, but the amended rule would also allow borrowers flexibility to negotiate favorable rates and other terms. As noted in an earlier Response, the Department declines to propose a two-track system, with one set of rules for purchase money mortgage transactions and another for refinances. The Department is not persuaded that purchase money mortgages differ from refinanced mortgages with respect to the risk to borrowers.

With regard to risk, the Department notes that in the traditional mortgage transaction in which borrowers pay a down payment, the down payment will be at risk in the event of foreclosure due to penalties, accrued interest and unpaid taxes. Viewed against this universally-accepted practice, the Department does not wish to impede those borrowers who wish to pledge money or securities in order to reduce or eliminate the need for a down payment or to negotiate other terms of the mortgage contract.

COMMENT: One commenter stated that if the rule were adopted, all borrowers could be harmed by a lender who overreaches and adds a security interest in all deposit accounts, particularly if there is no corresponding benefit to the borrower. The commenter stated that there is a greater danger of this occurring with refinanced loans because that is where predatory lending practices have largely been concentrated and because, in a home purchase situation, there is usually a licensed realtor and, in some situations, an attorney. The commenter noted that these outside representatives, while not taking a direct role in negotiating mortgage loans, play a meaningful role in alerting borrowers to inappropriate loan terms and help make unfair loan terms much less likely in a purchase money situation.

RESPONSE: The Department notes that lenders have a claim to borrowers' deposit accounts anyway by simply enforcing the borrower's obligation to pay on the loan.

COMMENT: One commenter stated that while pledged asset loans may present an affordable risk for certain consumers with substantial assets, that does not mean that these loans are suitable for everyone. The commenter urged the Department to set suitability standards for pledged asset purchase money mortgages. The commenter noted that some banks have self-imposed limitations, which reflect safety and soundness concerns, rather than consumer protection perspectives. Further, the commenter stated that pledging of assets is not a necessity and urged the Department to limit asset pledges to no more than ten percent of the borrower's intangible assets. The commenter stated that allowing licensed lenders to take security interests in certificates of deposit, savings accounts, checking accounts and small investment accounts is a step that would harm, not help, most low and fixed income consumers and should only be permitted with the suitability standards just noted.

RESPONSE: The Department disagrees that the Department should set standards. It believes the structure of the mortgage transaction and nature of the collateral should, subject to the limitations specified in the amended rule, be a matter of choice between the lender and the borrower, especially in the absence of a pattern of abuse. The Department notes that before the restrictive language was added to the rules in 2002, lenders had significantly more latitude than they have under the current rule and no significant pattern of abuse was noted along the lines suggested by the commenter. Therefore, the Department does not see the need to limit pledges to a percentage. Borrowers should be allowed flexibility to the extent permitted by the amendment. The Department disagrees that allowing lenders to take a security interest in CD's, savings accounts and checking accounts is harmful, as the borrower has an obligation to repay the loan in any regard.

Federal Standards Analysis

The current rule is very restrictive, permitting only a first lien on the mortgaged property to be used as security for the loan. The adopted amendment would liberalize this rule by permitting items other than household or personal goods to be used as security. The adopted amendment retains the prohibition against household and personal goods as part of the security for a first mortgage loan. The Department has analyzed this restriction in relation to existing Federal standards.

Generally speaking, there are Federal law standards or requirements that apply to both Federal and state chartered, licensed or authorized lenders, for example, the Real Estate Settlement Procedures Act, 12 U.S.C. §§2601 et seq. and the Truth in Lending Act, 12 U.S.C. §§

1601 et seq. To the Department's knowledge, there are no standards in these generally applicable laws that would be exceeded by the adopted amendment.

More directly relevant to the current fact pattern, the U.S. Government Sponsored Enterprises (Fannie Mae, Freddie Mac, and Ginnie Mae) have established underwriting standards that may have the effect of operating as a Federal standard because of the importance of the secondary market to the residential mortgage industry. While the Department's adopted amendment on what can be taken as security on a first lien loan may be more restrictive than these underwriting standards, the Department does not think that the restriction is so significant as to impede the proper functioning of the mortgage market. The Department notes that the Federal National Mortgage Association, a government sponsored enterprise involved in mortgage lending on a national scale, has reviewed the amendment and has determined that the amendment would not interfere with its programs or with the mission of the enterprise. The Department also notes that the effect of the amendment is to liberalize the current standard that the Department regards as being overly restrictive.

The Department did not consider the Federal law standards or requirements applicable specifically to Federally-chartered depositories. The scope of Chapter 15 generally does not extend to Federally-chartered depositories because all depositories are exempted from substantial portions of the first lien mortgage provisions of the Licensed Lenders Act by N.J.S.A. 17:11C-4. Beyond that are principles of Federal preemption of State law. Thus, the adopted amendment does not, in its effect, contain standards or requirements that exceed standards or requirements imposed by Federal banking law upon those lenders. There is also the possibility that stricter State standards would create an uneven playing field for New Jersey State-chartered depositories vis-à-vis their Federally-chartered competitors. The Department does not think that the

restriction contained in this adopted amendment is significant enough to constitute a burden on State-chartered institutions that would create an uneven playing field.

The most controversial group of lenders that would be affected by the adopted amendment is subsidiaries of Federally-chartered depositories. Generally, Federal regulators have taken the position that the operating subsidiaries of Federally-chartered institutions are exempt from many provisions of state law, while the Department and many other state regulators have taken the position that the subsidiaries, as separately-incorporated entities, are fully subject to state law, including licensing. Consistent with this position, the Department has concluded that the adopted amendment applies to subsidiaries of Federally-chartered depository institutions. Moreover, having considered the burden on those entities, the Department has concluded that the restriction is not so significant as to warrant a change in the adopted rule, given the public policy purpose sought to be achieved. The Department thinks that it is important to assure borrowers that their personal and household possessions will not be placed at risk in connection with a first lien residential mortgage transaction.

Full text of the adopted amendment follows:

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