

activities performed by the mortgage loan originators sponsored by the broker. In addition, brokers must submit financial condition reports to the NMLS. For brokers that are Fannie Mae or Freddie Mac Seller/Servicers or Ginnie Mae Issuers, the financial condition components are due within 45 days of the end of each calendar quarter; for brokers that are not, the financial condition components are due annually within 90 days of the broker's fiscal year end.

Reference: Sections 10166.07, 10166.13

SECTION 11 – Covered Loans - Financial Code Section 4970 et seq.

High-cost, high-fee loans as defined in Financial Code Section 4970, also called covered loans, are subject to certain limitations. Note: Additional rules will apply if the transaction also falls under Article 7. (See Section 7 – Article 7 – Regulated Loans.) A loan falls within the requirements of this statute if:

- it is a “consumer loan” secured by real property located in California that is, or is intended to be, used as the principal dwelling of the consumer that is improved by a one to four residential unit (but is not a reverse mortgage, an open line of credit defined in Part 226 of Regulation Z, a bridge loan as defined in Financial Code Section 4970(d), or a consumer credit transaction that is secured by a rental property or second home),
- the original principal balance does not exceed the most current conforming loan limit for a single-family first mortgage loan established by the Federal National Mortgage Association (FNMA) for a mortgage or deed of trust, and
- either:
 - the annual percentage rate at consummation of the transaction will exceed by more than eight percentage points the yield on Treasury Securities having comparable periods of maturity on the 15th day of the month immediately preceding the month in which the application is received by the creditor or
 - total points and fees payable by the consumer at or before closing will exceed 6% of the total loan amount.

Points and fees include the following:

- All items required to be disclosed as finance charges under Sections 226.4(a) and 226.4(b) of Regulation Z, including the Official Staff Commentary, except interest.
- All compensation and fees paid to mortgage brokers in connection with the loan transaction.
- All items listed in Section 226.4(c) of Regulation Z, only if the person originating the covered loan receives direct compensation in connection with the charge.

Does the broker arrange or make high-cost, high-fee loans that are covered loans?

Correct Procedure:

The following are prohibited acts and limitations for covered loans:

1. A covered loan cannot include a prepayment penalty after the first 36 months after the consummation of the loan.
2. A covered loan may include a prepayment penalty only if the person who originates a covered loan:
 - has also offered the consumer a choice of another product without a prepayment penalty;
 - has disclosed in writing to the consumer at least three days prior to loan consummation the terms of the prepayment penalty for accepting a covered loan with the prepayment penalty and the rates, points, and fees that would be available to the consumer for accepting a covered loan without a prepayment penalty;
 - has limited the amount of the prepayment penalty to an amount not to exceed the payment of six months advance interest at the contract interest rate then in effect, on the amount prepaid in any 12-month period in excess of 20% of the original principal amount; and
 - will not finance a prepayment penalty through a new loan that is originated by the same person.

A covered loan cannot impose a prepayment penalty if the covered loan is accelerated as a result of default.

3. A covered loan with a term of five years or less may not provide at origination for a payment schedule with regular periodic payments that do not fully amortize the principal balance as of the maturity date of the loan.

For a payment schedule that is adjusted for the seasonal or irregular income of the consumer, the total installments in any year cannot exceed the amount of one year's worth of payments on the loan. This requirement does not apply to a bridge loan as defined in Financial Code Section 4973(b)(2). Note: The definition of "bridge loan" for the purpose of this requirement is different than the definition of "bridge loan" when determining if a loan is a covered loan.

4. A covered loan cannot contain a provision for negative amortization such that the payment schedule for regular monthly payments causes the principal balance to increase unless the covered loan is a first mortgage and the person who originates the loan discloses to the consumer that the loan contains a provision for negative amortization that may add principal to the balance of the loan.

5. A covered loan cannot include terms under which periodic payments required under the loan are consolidated and paid in advance from the loan proceeds.

6. A covered loan cannot contain a provision that increases the interest rate as a result of a default. This does not apply to interest rate changes in a variable (adjustable) rate loan that are otherwise consistent with the provisions of the loan documents provided that the change in interest rate is not triggered by a default or the acceleration for the indebtedness.

7. A person who originates a covered loan cannot make or arrange a covered loan unless at the time the loan is consummated the person reasonably believes the consumers will be able to make the scheduled payments based on their current or expected income, current obligations, employment status, and other financial resources, other than the equity in the dwelling that secures the loan.

In a covered loan that is structured to increase to a specific designated rate at a specific designated date not exceeding 37 months from the date of application, the evaluation of the consumer's ability to repay the loan must be based on the fully indexed rate calculated at the time of application.

The consumer shall be presumed to be able to make the scheduled payments if, at the time the loan is consummated, the consumer's total debt to income ratio does not exceed 55% of their current gross income as verified. No presumption of inability to make the scheduled payment will arise solely from the fact that, at the time the loan is consummated, the consumer's total debt to income ratio including the covered loan, exceeds 55%.

In a stated income loan, the reasonable belief can be based on the income stated by the consumer and other information that the person originating the loan customarily obtains in connection with loans of this type. A person cannot knowingly or willingly originate a covered loan as a stated income loan with the intent or effect of evading this law.

8. A person who originates a covered loan cannot pay a contractor under a home-improvement contract from the proceeds of the loan other than by an instrument that is payable to the consumer, or jointly payable to the consumer and the contractor, or at the election of the consumer, to a third party escrow agent for the benefit of the contractor in accordance with the terms and conditions in a written escrow agreement signed by the consumer, the person that originates the loan, and the contractor prior to the disbursement of funds.

No payments, other than progress payments for home-improvement work that the consumer certifies is completed, can be made to a escrow account or jointly to the consumer and contractor unless the person who originates the loan is presented with a signed and dated completion certificate by the consumer showing that the home-improvement contract was completed to the satisfaction of the consumer.

9. It is unlawful for a person who originates a covered loan to recommend or encourage a consumer to default on an existing consumer loan or other debt in connection with the solicitation or making of a covered loan that refinances all or any portion of the existing consumer loan or debt.

10. A covered loan cannot contain a call provision that permits the lender, in its sole discretion, to accelerate the indebtedness. This prohibition does not apply if the repayment of the loan has been accelerated in accordance with the terms of the loan documents as a result of the consumer's default, pursuant to a due-on-sale provision, or due to fraud or material misrepresentation by a consumer in connection with the loan or the value of the security for the loan.

11. A person who originates a covered loan cannot refinance or arrange the financing of a consumer loan where the new loan is a covered loan that is made for the purpose of refinancing, debt consolidation, or cash out that does not result in an identifiable benefit to the consumer, considering the consumer's stated purpose for seeking the loan, fees, interest rates, finance charges, and points.

12. A covered loan cannot be made unless the "Consumer Caution and Home Ownership Counseling Notice" specified in Financial Code Section 4973(k) is provided to the consumer no later than 3 business days prior to signing the loan documents. It shall be a rebuttable presumption that the licensed person has met his obligation to provide the disclosure if the consumer provides the licensed person with a signed acknowledgement of receipt of a copy of the notice.

13. A person who originates a covered loan cannot steer, counsel, or direct any prospective consumer to accept a loan product with a risk grade less favorable than the risk grade that the consumer would qualify for based on that person's current underwriting guidelines, prudently applied, considering the information available to that person, including the information provided by the consumer.

A person will not be deemed to have violated this prohibition if the risk grade determination applied to a consumer is reasonably based on the person's underwriting guidelines if it is an appropriate risk grade category for which the customer qualifies with the person.

If a broker originates a covered loan, the broker cannot steer, counsel, or direct any prospective consumer to accept a loan product at a higher cost than that for which the consumer could qualify based on the loan products offered by the persons with whom the broker regularly does business.

14. A person who originates a covered loan cannot avoid, or attempt to avoid, this law by structuring a loan transaction as an open-end credit plan for the purpose of evading the provisions of this law when the loan would have been a covered loan if the loan had been structured as a closed-end loan or dividing any loan transaction into separate parts for the purpose of evading the provisions of this law.

15. A person who originates a covered loan cannot act in any manner that constitutes fraud.

16. A person who originates a covered loan must inform any employee who originates covered loans on behalf of the person of the administrative or civil penalties for a violation of this law.

17. Upon request, a person who originates a covered loan must provide the Department or the consumer, at no cost, documentation that clearly demonstrates whether any loan is a covered loan. The documentation must include, but not be limited to, a full disclosure of the original principal balance, the annual percentage rate, and the total points and fees, as defined in Financial Code Section 4970.

18. A person who provides brokerage services to a borrower in a covered loan transaction by soliciting lenders or otherwise negotiating a consumer loan secured by real property is the fiduciary of the consumer, and any violation of the person's fiduciary duties is a violation of this law. A broker who arranges a covered loan owes this fiduciary duty to the consumer regardless of whom else the broker may be acting as an agent for in the course of the loan transaction.

19. A person who originates a consumer loan cannot make a covered loan that finances points and fees in excess of \$1,000 or 6% of the original principal balance, exclusive of points and fees, whichever is greater.

20. A person who originates a covered loan cannot finance, directly or indirectly, into a consumer loan or finance to the same borrower within 30 days of a consumer loan any credit life, credit disability, credit property, or credit unemployment insurance premiums, or debt cancellation or suspension agreement fees. It is not a prohibition for these premiums to be calculated and paid on a monthly basis. "Credit insurance" does not include a contract issued by a government agency or private mortgage insurance company to insure the lender against loss caused by the mortgage's default.

Reference: Financial Code Sections 4970, 4973, 4978.6, 4979, 4979.5, 4979.6, 4979.7