

The Changing Mortgage Lending Landscape

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A number of market, regulatory and legislative developments are working together to reinforce the importance of consumer protection and internal controls in the area of banking and mortgage products. Whether it is mortgage loans, consumer loans, credit cards or other credit products, Congress, state legislatures, federal and state banking authorities and state attorney generals are looking at the products - their terms, disclosures and uses - for compliance with existing consumer protection and other laws. They are looking at the products and the lenders to determine whether enhanced disclosures are needed, whether additional education should be required prior to a consumer taking the product or whether there should be a different standard to determine if the consumer should take the product at all.

For several years, consumer groups and other observers of mortgage lending arena have stepped up the calls for a suitability standard that can be used by mortgage lenders. The mortgage industry is resisting the efforts and instead is promoting a uniform nationwide standard. With the change in the leadership in Congress in January 2007 and the changing interest rate environment, the debate between the two views has increased. The current political climate is not as supportive of a national standard that would preempt state laws as it was in prior years.

Against this backdrop, the federal bank regulators are becoming more concerned about the financial stability of the mortgage market and about the increasing rate of foreclosures, especially those foreclosures of subprime or nontraditional mortgage loans originated in the low interest rate environment of the past few years. Further, state legislatures continue to introduce, debate and enact anti predatory lending laws that result in uneven requirements for lenders depending on the organization and charter. The Department of Justice and state attorneys general also have imposed compliance requirements through enforcement. Some of these recent events provide examples of lending activity that will be scrutinized by state and federal regulators.

In the past year, the federal banking agencies have issued guidance to lenders that originate nontraditional mortgages. The Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators have issued joint suggested guidance for state mortgage lenders that is similar to that of the federal banking agencies. In the case of the state guidance, each state must adopt the guidance to make it applicable to state mortgage lenders. The guidance addresses safety and soundness as well as consumer protection concerns that the agencies have about the origination of nontraditional mortgage loans. The guidance generally addresses underwriting of the nontraditional mortgage products and the consumer disclosures. There is a concern that in an economy and housing market that is not as robust as it has been in the past few years and as interest rates rise, consumers will find that they are not able to afford the payments for loans once the interest rates have reset. As this happens, regulators and consumer groups look at what disclosures were given, whether the consumer understood them and whether there should be a suitability standard applied to these loans.

As a follow up to the issuance of the nontraditional mortgage lending guidance, the federal banking agencies have issued additional guidance to address the applicability of the guidance to traditional adjustable rate loans and related products.

The additional guidance has been issued for comment and discusses the criteria and factors that an institution should assess in determining a borrower's ability to repay subprime loan. The regulators refer to a number of prior issuances, including the Expanded Subprime Lending Guidance issued in 2001 and the Real Estate Lending Guidelines issued in 1992. The proposed statement clarifies that the agencies are concerned about adjustable rate mortgage products that are marketed to subprime borrowers with certain characteristics including:

- Offering low initial payments based on a fixed introductory rate that adjusts to a variable index rate plus a margin;
- Approving borrowers without appropriate documentation of income;
- Setting high or no limits on how much the payment amount of interest rate may increase;
- Containing products features likely to result in frequent refinancing to maintain an affordable monthly payment;
- Including substantial prepayment penalties; and/or
- Providing borrowers with inadequate information about the product features.

The draft guidance would place new restrictions on these types of loans. Lenders are urged to underwrite subprime mortgages by looking at the borrower's ability at final maturity to pay the mortgage at the fully indexed rate, assuming a fully amortizing repayment schedule. The guidance also would require that borrowers be qualified on their debt to income ratio. The regulators specifically mention their concern that lenders may not take the tax and insurance payments into account when approving a loan. For higher risk loans, lenders should verify income, assets and liabilities. Stated income and reduced documentation loans are not appropriate for higher risk loans unless the lender can look to mitigating factors.

The draft guidance addresses necessary consumer protection requirements. The agencies also note the risk of marketing these loans and reminds institutions about the risks of violating the Federal Trade Commission Act's section 5 prohibition against unfair and deceptive practices. Finally, the requirement that internal controls be adequate is addressed.

In addition to other risk management practices including underwriting standards, consumer protections and internal controls, the agencies also identified predatory lending considerations as a concern. The draft guidance refers to the predatory lending practices discussed in the agencies' Expanded Subprime Lending Guidance and lists three elements, at least one of which is found in a predatory loan.

- Making mortgage loans based predominately on the foreclosure or liquidation value of the borrower's collateral rather than on the borrower's ability to repay the mortgage according to its terms;
- Inducing a borrower to repeatedly refinance a loan in order to charge high points and fees each time the loan is refinanced; or

- Engaging in fraud or deception to conceal the true nature of the mortgage loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

As is sometimes the case, a look at an enforcement order issued by one of the federal banking agencies provides an example of how the agencies will enforce a rule or guidance. Several days after issuing the proposed subprime guidance, the FDIC issued an order against Fremont General Corp. and Fremont Investment & Loan. The order reiterates how lenders underwrite subprime mortgages and how to police third party brokers. The FDIC has provided an example of how the agency would like to see the proposed guidance implemented by lenders.

The FDIC clarifies that the analysis of the borrower's ability to afford the loan must include real estate taxes, hazard insurance, private mortgage insurance and homeowner association fees. Fremont may make assumptions about these fees when calculating the fully amortizing rate for the loan. The order states that the amount should not exceed 50 percent of the borrower's income. This is more stringent than the proposed guidance, which is not as specific.

The order also requires that subprime loans to borrowers who are in distress be restructured, if such restructuring can be done consistent with safe and sound underwriting. Finally, the FDIC requires Fremont to oversee third party brokers. This oversight includes due diligence, a selection process for brokers that evaluates the integrity of the broker, a mechanism for ensuring that brokers are not rewarded for persuading borrowers into taking unsound loans, and a system that disciplines problem brokers.

Although the issues addressed are different, another instructive enforcement action is an agreement reached by Countrywide Home Loans and then New York Attorney General Eliot Spitzer late in 2006. This settlement not only looks at alleged discrimination but the remedy has the beginnings of a suitability standard.

After a review of the Home Mortgage Disclosure Act data relevant to lending in New York, the Attorney General asserted that Countywide was more likely to originate high priced loans to Latino and black customers. The Attorney General maintained that, based on a statistical analysis, the differences could not entirely be explained by legitimate factors, such as borrower credit scores and debt ratios. Countrywide has agreed to establish a program that includes education for borrowers, additional monitoring of pricing and other discretionary decisions, additional monitoring of mortgage broker pricing decisions, compensation to the borrowers who improperly received a higher priced loan and additional consumer disclosures. In addition, Countrywide has agreed to provide additional fair lending training for loan officers and provide regular reports to the Attorney General.

This settlement is an example of some of the pitfalls of the expanded HMDA disclosures. Each of the federal banking agencies is reviewing the data carefully and they have all announced that they are concerned about some of the findings. In the current political environment, it is possible that there will be Congressional attempts to revise the reporting requirements to include additional data elements.

Mortgage lending has been a profitable business line for many lenders in the past years and many consumers have benefited from the development of new loan products and low interest rates. However, the federal and state regulatory environment is changing and the compliance risks of subprime lending programs that offer an array of products are great. As is seen in the proposed guidance and the Fremont order, it is not just compliance, the agencies are also looking at supervisory risks and the adequacy of internal controls. As the debate continues, the call for a suitability standard for mortgage lenders will continue. Both the Countrywide and the Fremont order provide useful guidance about some of the areas of concern to monitor in the area of mortgage lending.