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Mitigating Third-Party Risk for Mortgage Lenders

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I. Interagency Guidance on Nontraditional Mortgage Products, 71 Fed. Reg. 58609 (October 4, 2006)

A. "Nontraditional Mortgage Products"

i) Interest–only Loans – For an initial period of years, a borrower is required to pay only the interest due, during which time the rate may either fluctuate or stay fixed. Does not cover HELOCs (which are separately addressed by the Interagency Credit Risk Management Guidance for Home Equity Lending, May 2005).

ii) Payment Option ARMs – Allows the borrower to choose different payment options for an initial period of years, such as a minimum payment that could be less than the amount of interest owed, an interest-only payment, or a fully amortizing principal and interest payment. After the initial period, or if the loan reaches a negative amortization cap, the loan is recast to require fully amortizing payments over the remaining term.

B. Coverage

i) Applies without regard to credit quality, although special attention is paid to subprime loans.

ii) Applies to all banks, thrifts and each their operating subsidiaries, and to all bank/thrift holding companies and their non-bank subsidiaries, and credit unions.

C. Third-Party Risk Concerns

i) Disclosure Practices – Institutions must be sensitive to the marketing and disclosure practices of third-party originators, such as brokers and correspondents (regulators specifically rejected calls from the industry to

eliminate the third-party originator provisions). Guidance stresses that promotional materials, oral statements, etc. must inform the consumer about the relative benefits and risks of these products, including the risk of payment shock and negative amortization. See also Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products, 71 Fed. Reg. 58672 (October 4, 2006).

ii) Underwriting Standards – Should not be ceded to third parties with different business objectives, risk tolerances, and core competencies (e.g., care must be taken in outsourcing programs).

iii) Due Diligence and Monitoring – Initial and periodic due diligence of third-party originators is stressed, as is the need for monitoring procedures to track the quality of loans by both origination source and key borrower characteristics.

iv) Compensation – Guidance stresses the need for establishing third-party compensation criteria that avoids incentives for unsafe and unsound originations.

D. State Law Initiatives

i) Most states have adopted versions of the Guidance; however, it is unclear how they will be applied in practice.

II. Proposed Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10533 (March 8, 2007)

A. "Subprime" – Defined by reference to the Interagency Expanded Guidance for Subprime Lending Programs (February, 2001). Credit characteristics of a subprime loan include two or more 30-day delinquencies in the last twelve months, or one or more 60-day delinquencies in the last 24 months; judgments, foreclosure, etc. in the prior 24 months; bankruptcy in the last five years; credit score of 660 or below; and/or DTI of 50% or greater.

B. As proposed, will apply to the same entities as the Guidance on Nontraditional Mortgage Products, but is not limited to nontraditional mortgages.

C. Proposal focuses on both the appropriateness of loan terms and consumer disclosure.

D. Emphasizes strong initial and ongoing due diligence of third parties. Thus, as with the Guidance on Nontraditional Mortgage Products, there is an emphasis on making sure that third-party originators, such as brokers and correspondents, make appropriate disclosure to the consumer of the risks and benefits in subprime loan transactions.

III. Fremont Consent Agreement (March 7, 2007)

A. FDIC entered into a Consent Agreement with Fremont Investment and Loan Brea, California and affiliates.

B. Allegations included lax subprime mortgage underwriting standards and inadequate risk/benefit disclosures to consumers.

C. The terms of the Consent Agreement relating to underwriting and consumer information require Fremont to have policies, procedures and control systems that address not only bank personnel, but also brokers and correspondents.

D. In addition, Fremont must develop a mortgage broker monitoring program and plan, which, at a minimum, must provide for:

i) A due diligence process for entering into and maintaining relationships with brokers;

ii) A broker selection process that evaluates the integrity, character and financial viability of potential brokers;

iii) Compensation criteria designed to avoid giving incentives for broker originations that are inconsistent with "sound underwriting and consumer protection principles;"

iv) Procedures for monitoring broker compliance with agreements, bank policies and applicable law, and appropriate corrective action where a broker does not; and

v) Procedures for tracking which brokers generate substantial putbacks (measured as a fraction of the broker's loan volume) and implementing appropriate corrective action.

IV. OCC Advisory Letter 2003-3 - Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans

A. Covers national banks and their operating subsidiaries.

B. Applies to:

i) Traditional broker transactions;

ii) Table funded transactions; and

iii) Loan purchase transactions where the loan is initially made and funded by a third party who subsequently sells the loan to the bank (whether or not the bank participates in the underwriting).

C. Indicia of a "predatory" loan:

i) Underwriting based predominantly on the liquidation value of the collateral;

ii) Loan flipping;

iii) Fee packing;

iv) Fraudulent, deceptive or high-pressure sales tactics targeted at unsophisticated borrowers.

D. Risks

i) Direct liability in broker transactions;

ii) Assignee liability under TILA/HOEPA;

iii) Assignee liability under state high cost loan laws;

iv) Fair lending risk;

v) Adverse impact on CRA ratings; and

vi) Restricted access to the secondary market.

E. Mitigation

i) Policies to address when to purchase loans with certain characteristics (e.g., refinance of a subsidized loan; financed single-premium credit insurance, negative amortization, default interest rates, mandatory arbitration clauses, high cost loans);

ii) Policies to address points and fees caps and compensation issues, such as the use of overages and yield spread premiums;

iii) Appropriate initial and ongoing due diligence;

iv) Agreements with brokers and correspondents should reiterate the institution's lending policies and contain appropriate recourse for originations that do not adhere to those policies; and

v) Individual loan file reviews to ensure compliance with the bank's policies and, in the case of brokered loans, that there is appropriate documentation of a relationship between the consumer and the broker.

V. **Loan Pricing and the Countrywide New York Settlement (November 22, 2006)**

A. Arose out of a review of 2004 HMDA data and follow-on inquiries into loan-level data. Focus was on mortgage loans secured by New York property.

B. New York Attorney General alleged pricing discrepancies between loans made to Hispanic/black borrowers and non-Hispanic white borrowers due, in part, to pricing exceptions in the retail channel and broker compensation (combined front and back-end) in the wholesale channel.

C. Among other settlement terms, Countrywide agreed to modify its existing models, methodologies and analyses, as necessary, to perform periodic broker compensation regression analysis to identify:

   i) whether there are material pricing disparities between Hispanic/black borrowers and similarly situated non-Hispanic white borrowers, and

   ii) whether brokers with a significant black or Hispanic customer base have materially higher broker compensation than brokers with a predominantly non-Hispanic similarly-situated customer base within the same MSA.

D. Corrective action for brokers could run from training and education to termination of the relationship. Any broker with a pricing disparity of more than 65 basis points gets special attention.

E. Countrywide must instruct its New York brokers to disclose to applicants that reduced documentation loans generally are more expensive, and should offer to quote the applicant a price for a full documentation loan.

F. New York brokers must also be notified that fair lending training is available; that Countrywide has processes to monitor loans at the individual broker level for compliance with fair lending laws; and that Countrywide can take various remedial action against the brokers, including reducing compensation or terminating the relationship.

VI. **Appraisals**

A. FFIEC White Paper on Third-Party Mortgage Loan Fraud (issued February, 2005)

i) Red flags, internal control recommendations and best practices for various parts of the origination process (e.g., credit reports, escrows, mortgage brokers, title insurance, etc.) to help detect and prevent mortgage fraud.

ii) Detailed red flags and best practices to address appraisal negligence/fraud.

iii) Used as the basis for corrective action in the September, 2005 Consent Order between Argent Mortgage and Georgia Department of Banking and Finance.

B. Other Federal Banking Agency Guidance on Appraisal Practices and Appraiser Independence

i) Federal appraisal regulations. See, e.g., 12 C.F.R. §§ 34.41 – 34.47 (June 7, 1994). Addresses minimum standards for property appraisals and appraiser independence.

ii) Interagency Appraisal and Evaluation Guidelines (October 27, 1994). Describes the proper selection criteria for and monitoring of appraisers.

iii) Interagency Statement on Independent Appraisal and Evaluation Functions (October 28, 2003). Discusses the requirement that appraisers be independent (e.g., appraiser cannot have a direct or indirect financial or other interest in the transaction; bank cannot accept an appraisal prepared by a borrower-selected appraiser; etc.).

iv) Interagency FAQs on Appraisal Regulations and the Interagency Statement on Independent Appraisal and Evaluation Functions (March 22, 2005). Covers selection of appraisers, when a bank can accept transferred appraisals/appraisals ordered by someone other than the bank, and compliance reviews of appraisals.

C. Ameriquest Settlement – Appraisal Provisions

i) Ameriquest required to centralize its appraisal selection function away from the branch offices.

ii) For each state, there must be a panel of qualified, approved appraisers. Appraisals will be assigned to qualified appraisers by an algorithmic system that will consider the appraiser's familiarity with the geographic area; number of appraisals the appraiser can perform during a given period; the appraiser's record of responsiveness; the status of the appraiser's license; and, at the time of the request, whether the appraiser

has prior appraisals undergoing a pre- or post-funding review or an investor review.

iii) Appraisers who have been previously disciplined by their state licensing authority cannot be included on a panel.

iv) Ameriquest must comply with the federal banking agencies' Statement on Independent Appraisal and Evaluation Functions (October 28, 2003).

v) Process for appraisal reviews, second appraisals and appraisal audits.

vi) An appraiser must be paid regardless of whether a loan closes, and cannot receive any sort of bonus compensation for meeting a desired appraisal value. No Ameriquest employee can receive compensation from an appraiser for receiving assignments.

VII. **Miscellaneous Regulatory Risks**

A. RESPA Section 8(b) Markups

i) One settlement service provider marks up the cost of another provider's service without providing additional actual and necessary services. Ex) closing agent charges $60 recording fee, pays $20 to the recorder, and pockets the difference without performing any services.

ii) Some federal appellate courts have concluded that this does not violate Section 8(b), unless the mark-up is split among two or more culpable parties. See Echevarria v. Chicago Title and Trust Co., 256 F.3d 623 (7th Cir. 2001); Boulware v. Crossland Mortgage Corp., 291 F.3d 261 (4th Cir. 2002); Haug v. Bank of America, 317 F.3d 832 (8th Cir. 2003).

iii) While other federal appellate courts agree with HUD that Section 8(b) is violated in this situation, if the party keeping the mark-up has not performed bona fide, additional services. See Sosa v. Chase Manhattan Mortgage Corp., 348 F.3d 979 (11th Cir. 2003); Kruse v. Wells Fargo Home Mortgage, 383 F.3d 49 (2nd Cir. 2004); Santiago v. GMAC Mortgage Group, 417 F.3d 384 (3rd Cir. 2005).

B. Potential TILA Impact of Mark-ups

i) A charge otherwise excluded from the finance charge calculation (such as a recording fee) must be included if the charge is "unreasonable."

ii) While most courts have held that only the unreasonable portion of a charge gets included in the finance charge, see, e.g., Guise v. BWM Mortgage, LLC, 377 F.3d 795 (7th Cir. 2004), the issue is not free from doubt.

iii) While most mark-ups should not cause too much TILA trouble because of the $100 tolerance for money damages and the ½% and 1% tolerances for rescission, remember that the rescission tolerance in foreclosure is only $35. See 12 C.F.R. § 226.23(h)(2).

iv) And even outside of foreclosure, there can be problems if a court is inclined to include the entire amount of a charge in the finance charge and if the fee is large enough.

v) Mark-ups can also cause mischief with the HOEPA "points and fees" test, since a § 226.4(c)(7) fee that is not normally included in the calculation must be included if it is "unreasonable." See 12 C.F.R. § 226.32(b)(1).

vi) The few courts that have considered the question, have used the finance charge decisions to conclude that only the unreasonable portion of a fee must be included in the "points and fees" test. See Strong v. Option One Mortgage Corp., 2005 WL 1463245 (E.D.Pa. June 20, 2005).

vii) But again, the issue is not free from doubt. See Official Staff Commentary § 226.32(b)(1)(ii)-2 ("[A] reasonable fee paid by the consumer to an independent, third-party appraiser may be excluded from the 'points and fees' calculation (assuming no compensation is paid to the creditor)"). Does this mean that if the creditor shares at all in the appraisal fee the entire fee is included in the points and fees test, or only the portion in which the creditor shares. If the former, it could support an argument that if any part of a § 226.4(c)(7) fee is unreasonable, the entire amount must be included in the points and fees test.

viii) Plus, you have the risk of state regulators and courts reaching different conclusions under their state high cost loan laws.