

# **MBA's Regulatory Compliance Conference 2007**

## **Establishing Third Party Controls**

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Prepared by:

Lou Pizante, CEO  
Mavent Inc.  
3 Park Plaza, Suite 700  
Irvine, CA 92614  
(949) 474-4732  
[lou.pizante@mavent.com](mailto:lou.pizante@mavent.com)

- I. Federal Proposed Legislation with Third Party Control Provisions
  - A. Sen Dodd (D-CT) – Homeownership Preservation and Protection Act
    1. Includes YSP in calculating whether a loan is a HOEPA loan
    2. Creates a duty of good faith and fair dealing for lenders and brokers
      - (a) Imposes fiduciary duty on mortgage brokers
    3. Supplements existing lender liability for broker actions where YSP is paid
    4. Prohibitions on “steering”
    5. Hold lenders liable for any pressure “brought to bear on appraisers”
  - B. Sen Bachus (R- AL) Fair Mortgage Practices Act
    1. Creates national registration and licensing standard for mortgage originators
  - C. Sen Schumer (D-NY) – Borrowers Protection Act
    1. Establishes a fiduciary duty for brokers and other non-bank mortgage originators
    2. Holds lenders responsible for policing brokers and appraisers
    3. Prohibits steering
  - D. Rep Jones (D-OH) – Predatory Lending Practices Reduction Act
    1. Federal certification program for mortgage brokers and other agents involved in subprime loan transactions
      - (a) Includes written exam that covers, among other things, Truth in Lending, Fair Housing and Equal Credit Opportunity Act and other federal legislation

## II. CSBS/AARMR Model Exam Guidelines (MEGs)

- A. Currently covers non-trad and subprime products but a broader MEG is expected
- B. Indirect Originations through Third Parties Questionnaire
  - 1. Has the institution implemented systems and controls for establishing and maintaining relationships with third parties, including procedures for performing due diligence?
  - 2. What are those systems and controls?
  - 3. If appraisal. Loan documentation, credit problems or consumer complaints are discovered in third-party originations, does the institution take immediate action?
  - 4. What remedial actions are taken?
  - 5. What third-party compensation is established for Covered Transactions?

## III. Non-Traditional Mortgage Products

- A. What are the source documents and to whom do they apply?
  - 1. Final Interagency Guidance on Nontraditional Mortgage Product Risks
    - (a) Applies to federally insured banks and thrifts (national banks, federal savings associations, state banks, state savings associations and state savings banks, and state industrial loan companies) and their subsidiaries; federal and state credit unions; and bank and savings and loan holding companies; as well as their non-bank subsidiaries
  - 2. Final CSBS/AARMR Guidance on Nontraditional Mortgage Product Risks
    - (a) Applies to mortgage brokers and mortgage companies not affiliated with a bank holding company or an insured financial institution
- B. Scope: “Non-Traditional” includes such products as “interest-only” and “payment option” adjustable-rate mortgages (ARMs), products with no amortization or the potential for negative amortization over the first few years.
- C. Third Party Risk Requirements
  - 1. Loan Terms and Underwriting Standards
    - (a) Strong caution against delegating underwriting
    - (b) Oversight of the marketing and borrower disclosure practices
      - (i) Note: Regulators expressly rejected comments by industry to eliminate or modify third-party communications oversight provisions
  - 2. Portfolio and Risk Management Practices
    - (a) Strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence

- (b) Oversight of third parties must involve monitoring quality of lending practices and compliance with applicable laws and regulations
    - (i) Monitoring by both third party and key borrower characteristics
  - (c) Immediate remedial actions should include more thorough application reviews, more frequent re-underwriting, or termination of the third-party relationship
    - (i) Refer to OCC Bulletin 2001-47 – Third-Party Relationships and AL 2000-9 – Third-Party Risk (OCC). Federally insured credit unions should refer to 01-CU-20 (NCUA), Due Diligence over Third Party Service Providers. Savings associations should refer to OTS Thrift Bulletin 82a – Third Party Arrangements.
3. Consumer Protection Issues
- (a) Criteria for, conducting due diligence on and monitoring third parties
    - (i) Compensation should not promote unsound underwriting or “steer” borrowers to non-traditional products
  - (b) Focus on corrective actions in the event that the third party fails to comply

#### IV. Subprime Mortgage Products

- A. What are the source documents and to whom do they apply?
- 1. Final Interagency Statement on Subprime Mortgage Lending
    - (a) Applies to the same entities as does the Interagency Guidance on Non-Traditional Product Risks, above.
  - 2. Final CSBS/AARMR Guidance on Nontraditional Mortgage Product Risks
    - (a) Applies to the same entities as does CSBS/AARMR Guidance on Nontraditional Mortgage Product Risks, above
- B. Scope: The Guidance does not define the term “subprime loans.” Instead, it refers to previous Guidance issued by the Agencies, specifically, the 2001 Expanded Guidance for Subprime Lending Programs, which uses the term “subprime loans” generally to refer to loans products made to borrowers with the following terms and characteristics:
- 1. Borrowers
    - (a) Weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments and bankruptcies, and/or reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria
  - 2. Products
    - (a) ARMs with teasers
    - (b) ARMs with very high or no caps/ceilings
    - (c) Stated-income/low-doc loans

- (d) Loans with features likely to result in frequent refinancing to maintain low monthly payments
- (e) Loans that carry substantial prepayment penalties or penalties for prepayment that extend beyond the first adjustment

C. Third Party Risk Requirements

- 1. Underwriting Standards
- 2. Communications
  - (a) Advertising and communications must be clear and balanced about the relative benefits and risks of subprime products
  - (b) Communication must include disclosures relating to payment shock, prepayment penalties, balloon payments, cost of reduced documentation loans, and responsibility for taxes and insurance
- 3. Controls
  - (a) Requires establishing appropriate criteria for entering into and maintaining relationships with third parties, and conducting initial and ongoing due diligence on third parties
  - (b) Oversight of third parties must involve monitoring lending practices and compliance with applicable laws and regulations
    - (i) Note: Regulators expressly rejected comments by industry to eliminate or modify third-party control provisions
- 4. Compensation
  - (a) Compensation should not promote unsound underwriting or “steer” borrowers to non-traditional products

V. Countrywide New York Loan Pricing Settlement (Third Party Matters)

- A. Arose from NY Attorney General's findings that Countrywide's 2004 HMDA data revealed black and Hispanic borrowers were more likely than white borrowers to receive rate spread threshold loans
- B. Consumer Education Program (at a cost of no less than \$3 million) to inform consumers at no cost about the home buying and mortgage application process
  - 1. A specific topic identified was the role of mortgage brokers and how they are compensated
- C. Broker compensation regression analyses
  - 1. Examine material disparities in broker compensation for black/Hispanic customers as compared to white customers
  - 2. Examine whether brokers with a significant black/Hispanic customer base received materially higher compensation than brokers in other similarly-situated customer bases within the same MSA
  - 3. If material disparities were revealed, Countrywide agreed to take appropriate corrective action against the broker, including: counseling, mandatory fair

lending training, enhanced scrutiny of broker's loans, reducing of broker compensation, and severing of the broker relationship

4. If the broker compensation regression analyses revealed more than a 65 basis points disparity, Countrywide agreed to identify the broker and advise high disparity brokers that Countrywide may terminate the relationship
  - (a) If the broker failed to either demonstrate that the disparity was due to a legitimate non-discriminatory reason, or that the broker had taken appropriate remedial actions, Countrywide agreed to promptly reduce the broker compensation by at least 20% and terminate the broker relationship if the disparity persisted
5. Countrywide agreed to instruct NY brokers to disclose the relative costs and benefits of reduced documentation loans
6. Countrywide agreed to advise in writing all of its brokers that training is available, they'll be closely monitored for fair lending, and Countrywide will take remedial steps to correct fair lending abuse