

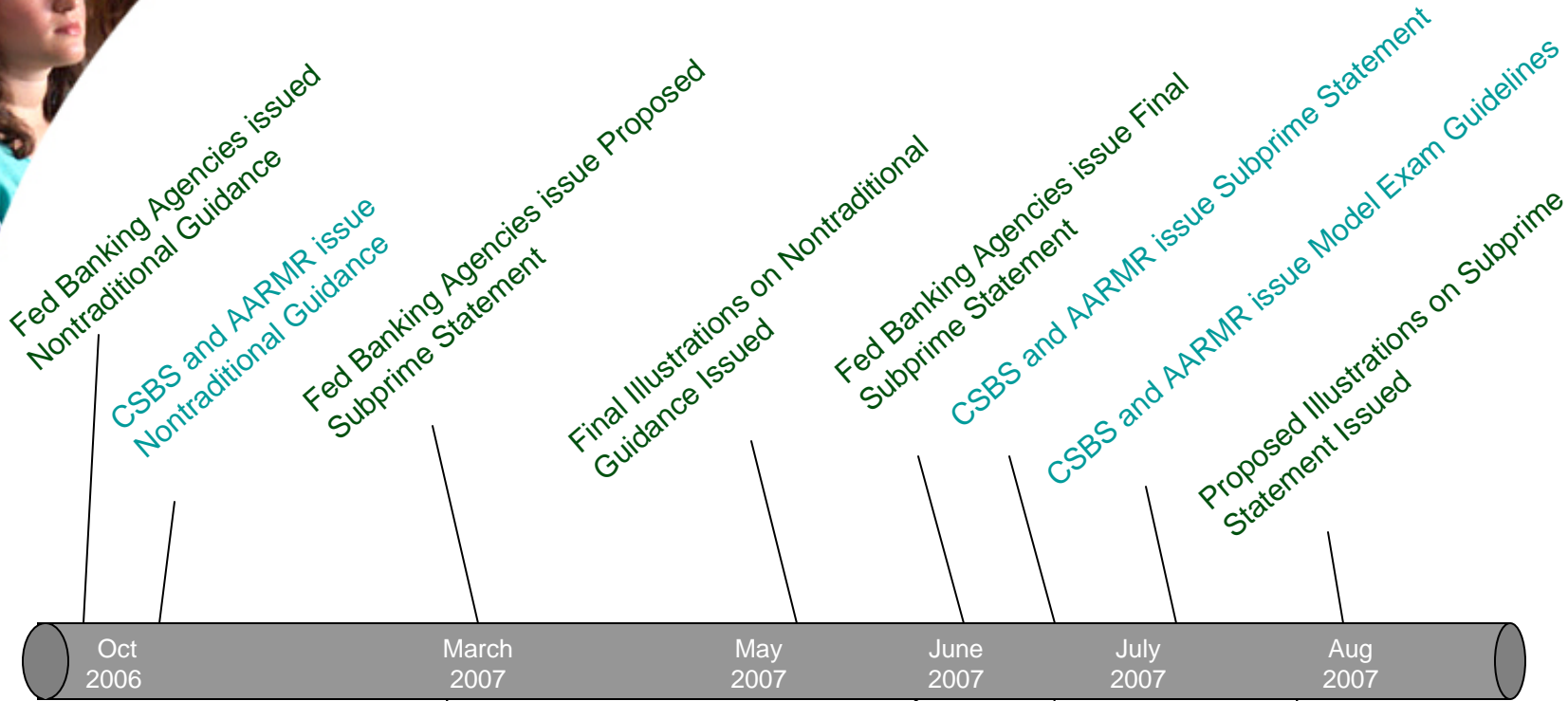
LEGAL RISKS

Under Interagency Guidance and Subprime Statement

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Key Dates



FDIC Issue C&D Order against Fremont

FRB holds HOEPA hearing

Announce Joint Program (Fed Bank Agencies, CSBS, AARMR) Compliance Reviews

OTS issue ANPR on UDAP

- Does not define “nontraditional mortgage loan,” although suggested that it include “residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest.”
- Does not include reverse mortgages and HELOCs, but does include IO and products with neg am potential
- Applies to insured depository institutions and their subsidiaries.
- Does not prohibit nontraditional mortgage products; rather focus of the guidance is on the higher risk elements of these nontraditional mortgage loans.

- Strongly cautions lenders to use stringent underwriting criteria, such as:
 - Assess borrower’s ability to repay using fully indexed rate, fully amortizing monthly payment amount
- Provides normative instructions for loan terms that lenders are encouraged to avoid and risk management practices that lenders are encouraged to adopt,
 - For example: stated income or reduced doc loans require more diligence and mitigating factors
- Encourages lenders to provide clear and balanced info in promotional materials and product descriptions to help borrowers make informed decisions.

Federal Banking Agencies Subprime Statement

- Addresses underwriting requirement/restrictions, loan features, and consumer protection principals for loans to “subprime” borrowers.
- Unclear what is a subprime borrower.
- Unclear whether the requirements in the Statement apply to all loans to those borrowers, or just certain type of loans, or loans with certain features.
- Also unclear is the type of products subject to the Statement loan products (i.e., ARMs with payment shock) (aside from 2/28s).

- If Statement applies to a given loan to a given borrower:
- Assess ability to repay (by loan's final maturity, at the fully indexed rate and assuming a fully amortizing repayment schedule).
 - Verify and document borrower's income, assets, and liabilities (low-doc/no-doc under mitigating factors, such as substantial liquid reserves or assets).
 - Establish clear policies governing the use of risk-layering features.
 - DTI analysis should include PITI as a percentage of monthly income.
 - Borrower should receive clear and balanced information.

- CSBS/AARMR issued substantially parallel guidance “to promote consistent regulation of the mortgage market.”
- At least thirty-four states have “adopted” the CSBS/AARMR’s Nontraditional Guidance.
- At least twenty-seven states have “adopted” or are considering the adoption of the CSBS/AARMR Subprime Statement.

States “adopted” Guidance and Statement in various ways

- Formal approach – regulators issued proposal, incorporated Guidance by reference and requested public comment (MA, NC, OH).
- Many other state regulators simply issued a press release announcing that they had adopted the guidance.
 - Some have touted the Guidance as a set of “best practices” (GA, HI, MI).

Agencies Authority to Enforce Policy Statements

- Virtually every state has enacted or adopted some version of the model APA to issue rules and regulations; with no notice and comment rulemaking process, not binding
 - Some APA statutes expressly provide that an agency statement is not valid against the public unless the agency has observed proper APA rulemaking procedure
- Therefore, how can state agencies enforce and administer the guidance (or even adopt it in the first place)?

What legal effect do “Guidance” and “Statements” have?

Although not law or regulations, there are possible legal risks for noncompliance

– Regulatory Risk

- Examination
- Enforcement

– Litigation Risk

- State implementation of specific underwriting criteria addressed in Guidance/Statement
- UDAP/Class action

– Transactional Risk

Regulatory Risk – Enforcement Action - Fremont Example

- Prior to issuance of the proposed Subprime Statement, the FDIC required Fremont Investment & Loan to cease and desist from subprime lending practices expressly covered by the Statement. FDIC presumably determined these practices, among others, to be unsafe and unsound:
 - Qualifying borrowers for loans with low initial payment based on an introductory rate, without an adequate analysis of the borrower's ability to repay at the fully indexed rate.
 - Approving borrowers without considering appropriate documentation and/or verification of their income.
 - Including features likely to require frequent refinancing to maintain an affordable monthly payment and/or to avoid foreclosure.

- It is unclear whether state agencies have the legal authority to enforce the “adoption” of the Guidance/Statement if no formal procedures were used.
- Yet, state regulators may still attempt to enforce the Guidance/Statement through enforcement actions, such as:
 - License revocation
 - Cease and desist orders
 - AG Action
 - Required Recordkeeping (i.e., MI, NY)

- The Guidance and the Statement tell bank examiners what kind of practices are “unsafe,” “unsound,” or “unfair” to consumers – but it is an open question how literally bank examiners will enforce it.
- The AARMR and CSBS Model Examination Guidelines (MEGs) are not a required standard although can be used for multi-state exam and enforcement actions. How the MEGs will be enforced on the state-level is still an open question.

Litigation Risk – State Implementation - Colorado

- Other states, such as Colorado, Maine, Minnesota, Nevada, NC and Ohio have enacted specific underwriting criteria based on Guidance/Statement.
- For example, Colorado, effective July 1, 2007
 - Makes it unconscionable for broker or lender to engage in a pattern or practice of providing residential loans based predominantly on liquidation value of the consumer's collateral without regard to the consumer's ability to repay.
 - Imposes a duty of good faith and fair dealing on mortgage brokers. Brokers must make a reasonable inquiry concerning borrower's current income, debts, and other obligations, and use best efforts to recommend appropriate loan.
 - Violation of these provisions constitutes a deceptive trade practice and permits a private right of action.

Litigation Risk – State Implementation – Maine effective January 1, 2008

- Creditor cannot extend a “subprime mortgage loan” unless a reasonable creditor would believe the borrower could repay the loan (based on factors set forth in the statute).
- “Subprime mortgage loan” is:
 - Nontraditional mortgage as defined in the guidance,
 - A rate spread home loan reportable under HMDA, or
 - A high rate-high fee mortgage
- Damages for a violation include actual, statutory, and punitive (if violation is malicious or reckless).

- “UDAP Happy” Climate
 - This summer the FRB has been seeking comments on whether it should regulate unfair and deceptive practices in the mortgage industry under HOEPA.
 - Further, the OTS issued an ANPR to assess whether it needs to prescribe additional regulation to prevent unfair or deceptive practices in the industry.

- Section 5 of the FTC Act declares it unlawful to engage in “unfair methods of competition” and “unfair and deceptive acts or practices” in or affecting commerce.
- A practice is unfair if it causes (or is likely to cause) substantial injuries that reasonable consumers could not avoid and is not outweighed by countervailing benefits to consumers or competition.
- A practice is deceptive if it is likely to mislead reasonable consumers and the misleading representation (or act or omission) is material.
- No private right of action under the FTC Act; FTC has authority to pursue admin/civil remedies for violations.

Unfair and Deceptive Practices in the Mortgage Industry

- Most states have enacted consumer protection legislation to parallel and expand the FTC Act (“little FTC acts”).
- Little FTC Acts generally provide a private right of action and AG enforcement.
- Effective January 1, 2007 Ohio amended its little FTC Act to specifically apply to mortgage lending, including a prohibition on engaging in a consumer transaction knowing there was no reasonable probability of payment by the consumer.

Although Guidance and Statement are not “law,” noncompliance with them may be a violation of reps and warranties in contracts with investors that state that the lender originated the loan according to “applicable requirements.”

- As announced on August 16, 2007, Fannie requires compliance with Statement and a new rep and warrant:
 - “In connection with transactions involving Covered Mortgage Loans, the seller represents and warrants that the mortgage complies in all respects with the Statement (or comparable state guidance), including the underwriting and consumer protection portions of the Statement. Regulated sellers may rely on interpretations, applications, or implementation plans of the Statement (or comparable state guidance) as communicated and/or agreed to by their regulator.”
 - This representation and warranty will apply to all sellers, including those that are not subject to the Statement at the federal or state level.
- All Covered Mortgage Loans with application dates on or after September 13, 2007, must be in compliance.

- Guidance/Statement: binding and mandatory, or simply a statement of policy?
- If a statement of policy, will examiners use the guidance as a road map for analyzing practices, and what happens if an examiner finds variance?
- Will the state agency or private plaintiffs' counsel attempt to assert that a practice that arguably is inconsistent with the policy is a UDAP violation?
- Will the guidance apply to mortgage servicers or purchasers that are subject to licensing and regulation by many states?