



# Quality Control

## Eyes and Ears for Compliance? And Regulatory Update

# PRESENTATION OUTLINE



## **This Presentation Covers: 1. How the QC Process Facilitates Regulatory Compliance Effort and 2. Latest and Upcoming Regulatory Developments**

- We begin with the discussion of the difference between QC and Compliance Roles
- What the Compliance Department needs from the QC Department
- What is the impact of the recent regulatory developments over the past year
  - Credit policy is becoming more and more a matter of law and regulatory guidance
  - The compliance officer role is expected to become more involved with what was once the exclusive province of the credit officer
  - The interface between QC and compliance is changing accordingly
- Survey of changes in various states impacting credit policy standards

# COMPLIANCE v. QUALITY CONTROL




## Compliance Management and QC are Fundamentally Different Functions

- **Similarities between Compliance and QC**
  - Both have a mandate for monitoring
  - Both have a hand in ensuring the remediation of control issues
  - Both are expected to provide management with feedback in terms of reporting
- **Key Differences between the two functions**
  - A compliance manager has a specific mandate to work with operations to develop and enforce procedures that ensure compliance with applicable laws and regulations
  - The QC manager often has a broader scope that includes risk areas that have compliance playing a subordinate role (e.g., fraud investigations and third party monitoring)
  - The scope of compliance is properly limited to dealing with matters that are guided by applicable regulations or statutes
  - Both functions are properly viewed as essential components of an institutions “control environment.”



## Compliance Departments Should Consider Leveraging QC for Compliance Monitoring

- **The monitoring function requires specialized skill sets**
  - Need for a valid statistical sampling methodology that allows for extrapolation
  - Supplement with a targeted “adverse file selection.”
  - QC file review specialists typically have a broad range and depth of mortgage industry experience
- **Business Synergy**
  - A robust QC program that incorporates compliance monitoring on behalf of the compliance department results in one group touching a single set of files, with a single questionnaire, as opposed to two separate departments touching separate sets of files using two separate questionnaires
  - Compliance monitoring can be facilitated by various QC software programs
  - So long as the compliance questions in a QC questionnaire have been reviewed and approved by compliance and legal, and the file reviewer has been trained on how to test for compliance issues, there is nothing wrong with QC performing a review of compliance metrics



## Increased Foreclosures Have Led to New Regulatory Actions

- Delinquencies and foreclosures have risen in all loan categories.
- Ohio, Indiana and Michigan account for 8.7 percent of the mortgage loans in the country, but account for 19.9 percent of the nation's loans in foreclosure and 15.0% of all of the foreclosures started in the country during the first quarter.
- Without these three states, the percent of loans in foreclosure in the US would be below the average over the last 10 years.
- The economy is to blame for much of today's issues not product types. A cooling real estate market makes resets more challenging in the subprime market.

# RECENT REGULATORY DEVELOPMENTS

## Federal

### The Interagency Guidance on Non-traditional Mortgage Product Risks (the “Guidance”)

- The Guidance was the first response to regulatory concerns
- Basic Requirements of the Guidance (Highlights)
  - Coverage
    - Applies to “Non-traditional Products” which is defined as products with a deferred interest or interest only feature
    - Does not apply to Hybrid ARMs (2/27 and 3/28s) unless they have these features
  - Underwriting
    - Nontraditional products need to be qualified at the fully indexed rate, assuming a fully amortizing payment schedule
    - Stated income or other reduced documentation is permissible so long as there are clear mitigating factors
    - Risk layering is permissible on the same grounds

# RECENT REGULATORY DEVELOPMENTS

## Federal

## The Interagency Guidance on Non-traditional Mortgage Product Risks (the “Guidance”)

- **Basic Requirements of the Guidance (Highlights) cont’d**
  - **Consumer Protection**
    - **Communications should tell relative benefits and risks of payment shock and the risk of negative amortization**
    - **Provide Information at crucial decision points, when borrowers are shopping for loans**
    - **Servicing - Monthly payment statements for deferred interest loans must disclose borrower’s current loan balance, portion of previous payment that was allocated to principal versus interest, and if applicable, amount by which principal balance increased**
    - **Communications with consumers, including ads, oral statements, promotional materials and monthly statements should provide “clear and balanced information”**
    - **Followed by Regulators’ Illustrations**
  - **Risk Management**
    - **Assure institutions’ policies set acceptable levels of risk in operating practices, accounting procedures and policy exception tolerances**
    - **Robust third party monitoring requirement**
- **Other Points**
  - **Specifically rejects a formal “suitability standard”**

## Over 30 States Have Adopted the Guidance With More Sure to Come

- **Several States have adopted the Federal Guidance**
  - The American Association of Residential Mortgage Regulators and the Conference of State Bank Supervisors issued model guidelines for use by state regulators that examine mortgage lenders and brokers offering subprime and nontraditional mortgage loans.
  - [www.aarmr.org/pdf/MEGs%20-%20Version%201.pdf](http://www.aarmr.org/pdf/MEGs%20-%20Version%201.pdf)
  - [www.aarmr.org/pdf/CSBS-AARMR%20FINAL%20GUIDANCE.pdf](http://www.aarmr.org/pdf/CSBS-AARMR%20FINAL%20GUIDANCE.pdf)
  - [www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/Final\\_CSBS-AARMR-NACCA\\_StatementonSubprimeLending.pdf](http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/Final_CSBS-AARMR-NACCA_StatementonSubprimeLending.pdf)
  - California is considering codifying the Guidance in regulations governing state licensees
- **For Further Information Regarding AARMR and CSBS Exam Guidelines:**
  - [www.aarmr.org](http://www.aarmr.org)
  - [www.CSBS.org](http://www.CSBS.org)

## Shortly After Adopting the Guidance, The Agency Issued the Statement on Subprime Mortgage Lending

- **The Scope of the Subprime Statement**
  - The Statement applies to Subprime ARMs for certain, and many in the industry are applying the statement to subprime fixed rate products
  - Applies to ARMs with one or more of the following features
    - Low interest rate that expires after a relatively short period
    - Lack of limitations on how high the interest rate can go on the reset date
    - Limited or stated income doc types
    - Product features likely to result in need to refinance in the near term to maintain affordable payment
    - Excessive prepayment penalties
    - Prepayment penalties that exceed the initial introductory period
- **To Be In Compliance With The Statement a Lender Must:**
  - Underwrite the subprime ARM at the fully indexed rate assuming a fully amortizing payment schedule
  - Determine a borrowers ability to repay by documenting income (Stated Income requires clear mitigants for subprime products)
  - Disclose the amount of taxes and insurance in the monthly payment
  - Allow a borrower to refinance out of an ARM product at least 60 days prior to the expiration of the introductory period **WITHOUT PENALTY**

## Defining What is “Subprime”: Where to Draw The Line

### Defining Subprime

- The Statement defers to the 2001 Expanded Interagency Guidance on Subprime Lending in defining what it means for a loan to be “subprime”
- The 2001 Expanded Subprime Guidance admonishes that a subprime borrower displays a reduced repayment capacity and are typically borrowers with impaired credit history’s, including but not limited to the following
  - Higher than average probability of default as evidenced by a FICO of 660 or below (with product and collateral as sub factors); and/or
  - Back-end DTI of 50% or greater, or otherwise impaired ability to pay for living expenses after subtracting debt service requirements from gross monthly income
  - Two or more 30-day delinquencies in the prior 12 months, or one or more 60 day delinquencies in the last 24 months
  - Judgment, foreclosure, repossession or charge off within the prior 24 months
  - Bankruptcy in the past 5 years.

### Additional Thoughts

- Some regulators will allow a lender to treat loans where the FICO is less than 660 as an Alt-A product rather than pure subprime so long as there are mitigants
- It is very unlikely that a FICO of 620 or below would be treated as anything other than subprime



## Stated Income and Alt Doc Loans Are Under Assault Across the Country

- **Some States Have Banned Stated Income Outright**
  - Minnesota HB 1004 and SB 988 prohibit a broker or licensee from relying on a borrower's statement of income in determining ability to repay (effectively kills stated income in MN)
  - Illinois SB 1167 appears to do the same
- **Others Have Significantly Curtailed it**
  - Nevada Assembly Bill 440 has a requirement for a licensee to determine ability to repay, but does not expressly preclude stated income the way IL and MN statutes do
  - PA appears to be leaning toward amending its banking regulations to require income documentation (by revising Title 10, Part IV, Chapter 46 Section 42); however, these revisions have not yet been formally adopted
  - OH Senate Bill 185, some have viewed this anti-predatory lending legislation to curtail stated income and alt-doc lending



## Many Regulators Now Requiring NTB Testing

- Federal banking regulators are requiring a net tangible benefit to the borrower test be applied to all refinance transactions on the borrower's principal dwelling
- Test expected to have "hard" benchmarks and thresholds (underwriter attestations not sufficient)
- Some states anti-predatory lending legislation requires the loan to have a benefit to the borrower (NM, SC, MA, OH and RI)

# IMPORTANT NON-REGULATORY DEVELOPMENTS



## DODD PRINCIPLES

- Concerns about borrowers facing resets led to the Dodd Principles
- Signed by several lenders and MBA
- Principles include:
  - Early contact with borrowers
  - Modify loans to create long term affordability
  - Dedicated staff and resources
  - Low-cost refinancing
  - Credit availability
  - Maximize success, minimize damage
  - Accountability
- Follow-up from Schumer and State AGs

# PENDING REGULATIONS

## Federal Reserve HOEPA Hearing

- Federal Reserve Conducted a HOEPA Hearing in June, 2006 and Will Likely Propose New UDAP Rules (Early Autumn)

### Hearing Considered

- Determining borrower's ability to repay
- Stated income and alt/no doc loans
- Prepayment Penalties
- Requiring escrows for taxes and insurance

Industry in its post-hearing comments preferred disclosure rather than UDAP rules

# PENDING REGULATIONS



## OTS UDAP Advance Notice of Proposed Rulemaking

- OTS Has Published an Advanced Notice of Proposed Rulemaking (ANPR) Dealing With Unfair and Deceptive Acts
- Asks whether OTS should:
  - Expand its current, limited, prohibitions against unfair or deceptive acts or practices, i.e. requiring confession of judgment, misrepresenting co-signer liability, imposing an unjust delinquency charge
  - Issue guidance generally defining where acts or practices are unfair or deceptive
  - Convert recent interagency guidance, e.g., nontraditional, subprime, others into rules
  - Develop guidance similar to OCC's or HUD's Housing Goal Rules
  - Follow state law models like Michigan and list prohibited practices
- **COMMENTS DUE NOVEMBER 6**

# PENDING REGULATIONS



## RESPA Is Returning

- **The President and HUD Secretary have announced that new RESPA rules will be issued by the end of the year**
- **Indications it will include:**
  - **Comparable GFE and HUD-1**
  - **Possibly categories of fees**
  - **Mortgage broker fee disclosure**
  - **Means of protecting borrowers from cost increases**
- **MBA has proposed options on its website [www.mortgagebankers.org](http://www.mortgagebankers.org)**

# PENDING LEGISLATION



## Legislation Has Been Proposed and Is Pending

- Senator Schumer's PL Bill – "Borrower's Protection Act of 2007" introduced May 3, 2007
- Rep. Bachus' PL Proposal
- Senator Dodd's PL Proposal
- Rep. Barney Frank's PL Ideas

# PENDING DEVELOPMENTS



## Common Concepts of PL Bills and Ideas

- Brokers/Regulation
- Broker and Lender Duties of Care
- Tightened HOEPA Triggers/PPP and YSP
- HMDA Trigger – “Subprime” Loans
- Ability to Repay – Low Documentation Loans
- Anti–Steering protections
- Assignee Liability
- Escrows
- Appraisals
- Enforcement



## Continue to Foster Homeownership and Credit Availability

- Don't choke off innovation and good credit to homebuyers and those who seek to refinance
- Support
  - **Greater Transparency**
  - **Greater Financial Literacy**
  - **Uniform National Predatory Lending Standards**