



# THE CASE FOR NATIONAL REFORM

**As the mortgage industry becomes more entangled in state regulations, it might be time for a strong federal stance**

By **Douglas L. Davies**, partner, and **Bruce Volbeda**, summer associate, Lane Powell PC

**T**he mortgage-lending industry has been weathering a sea change in public perception and policy in the past decade. It has not only produced substantial beneficial reform but also a regulatory rat's nest. As a result, real estate finance has become one of the economy's most heavily regulated sectors, tangled in myriad, piecemeal rules that change from one jurisdiction to the next.

Most recent regulation has come in the form

of new state laws — often termed “anti-predatory-lending legislation” — that set state-specific rules. That patchwork is overlaid with an elaborate system of federal regulations that have accumulated in the past 40 years. Their acronyms have become household words for the profession: TILA, RESPA, HOEPA, ECOA/FHA, etc.

Considering these rules as well as the impact of recent legal settlements, the time has come for comprehensive federal reform to create a simple,

consistent and uniform national system that will benefit consumers and the industry alike.

In addition to the rule-proliferation at the state and national levels, mortgage companies have increasingly accepted settlements of agency investigations to avoid the expense of onerous litigation. These settlements have the virtual effect of black-letter law to others in the industry, despite the absence of legislative or judicial participation. This “legislation by attorney general” has changed the mortgage landscape dramatically, as demonstrated by the recent Ameriquest Mortgage Co.<sup>1</sup> settlement, among others.

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*1. Editor's note: Although Scotsman Guide's editorial policy prohibits direct mention of companies in article text, the informational and historical nature of this and subsequent references in this article dictates their inclusion.*



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Mortgage institutions also have contemplated eliminating services in some hamstrung states. And mortgage brokers — who originate the vast majority of home loans — often lack in-house counsel or compliance departments to help them navigate this legal thicket. Large and small players alike are vulnerable to inadvertent violations, and as regulations increase, so does litigation.

Admittedly, previous federal efforts toward these ends have not been helpful. The primary backdrop for the recent regulatory frenzy is a logjam of federal statutes and regulations.

Among them, the Truth in Lending Act (TILA) (1968) established strict lender disclosure requirements; the Real Estate Settlement Procedures Act (RESPA) (1974) requires good-faith estimates of settlement costs and prohibits kickbacks; and the Equal Credit Opportunity Act and Fair Housing Act (ECOA/FHA) (1974) regulate the evaluation of an applicant's credit and apply Title VIII of the Civil Rights Act.

Other oversight derives from the Department of Housing and Urban Development (HUD) and Federal Trade Commission regulations, the Home Ownership and Equity Protection Act (HOEPA) (1994), the Office of the Comptroller of the Currency and the Patriot Act.

## State regulatory efforts

In addition to federal law, states have jumped into the fray by generating a raft of legislation and regulations while waving anti-predatory-lending banners. They primarily have focused on the nonprime market, with its growing number of allegations of fraud or deceptive practices. This increase in state regulation should not be surprising: In 1993, there were 18 state mortgage regulators. In 2006, there are 48.

The market itself also has expanded. The 1990s saw the emergence of home-loan programs to reach underserved borrowers, such as those with spotty credit, unpredictable incomes or other financial challenges. In 1994, mortgages issued to nonprime borrowers totaled \$34 billion; less than a decade later, in 2002, they amounted to \$213 billion. They now comprise more than 30 percent of all mortgage lending.

State efforts to regulate this industry offer important lessons and warnings. North Carolina arguably initiated the anti-predatory-lending regulation boom in 1999. California quickly followed suit. Then Georgia joined the bandwagon with harsher legislation that went above and beyond existing federal regulatory requirements.

Because Georgia chose to expose loan

assignees and their investors to unlimited damage awards, some financial-ratings agencies refused to rate portfolios that included Georgia mortgages. With the marketability of its loans threatened, the state recanted seven months later, effectively repealing the statute.

Just this past June, Ohio Gov. Bob Taft signed one of the most-prominent state regulatory schemes into law at the home of a Columbus, Ohio, couple who allegedly had suffered because of a broker's fraudulent loan advice. While the publicity flourish drove home the admirable intent of such legislation, its requirements have left a number of mortgage companies wondering whether they still could do business in Ohio.

The 135-page Ohio law has been characterized as the "most comprehensive" legislation of its kind. It applies to any home loan with costs of 5 percent or greater and provides for awards of treble damages and attorney's fees through incorporation of the state's Consumer Sales Practices Act. The law also holds lenders responsible for determining loan applicants' "mental or physical infirmity."

Likewise, this past July, Rhode Island enacted the Home Loan Protection Act. Among other things, the act lets borrowers rescind their loan if its provisions against flipping are violated. This provision comes close to imposing unrestricted liability on loan assignees. This liability greatly impairs the value and the investment-grade rating of these loans to secondary-market investors.

In addition, Illinois' Predatory Lending Database Law requires lenders to submit detailed borrower data to the regulator, who then determines whether the borrower needs counseling or other services. Part of the law was intended to address discrimination, but its solution smacks of Big Brother surveillance.

There are now about 30 states and 17 localities imposing anti-predatory-lending standards.

Not all state efforts have been harmful, of course. A group that comprises representatives from 20 state regulators has been working toward establishing a national licensing system and uniform mortgage applications.

## Settlements set benchmarks

Other elements complicate this regulatory landscape. Most notable are settlement agreements entered into during investigations and litigation against mortgage brokers and lenders by state and federal authorities.

The subtext of these agreements (as publicly articulated by more than one state attorney general or regulator) is that the settlement terms become new benchmarks — even for mortgage-industry professionals who

were not a party to the lawsuit or investigation. Although mortgage brokers and lenders may comply with every law and court decision on the books, if they don't follow terms of the latest out-of-court settlement, they risk investigation by a state regulator or attorney general following the settlement-agreement standard.

Several high-profile settlements have fit this bill in the past few years. Most recently, Ameriquest settled an investigation initiated by 49 attorneys general in January 2006 for \$325 million.

Two swords hang over the heads of mortgage companies confronted with these investigations. First is the devastating cost of the investigation and subsequent litigation. Second is the drop in lender ratings with investors when a state sues.

The pressure to concede to demands is therefore enormous. The payoff for submission can be equally compelling: History has shown dramatic restoration of ratings confidence by the secondary market when a target company agrees to comply with state attorney general demands. A compliant company, after all, represents the most current state of the law in mortgage practice, and the market has naturally responded favorably to that halo of immunity.

## Ameriquest implications

Because 49 state attorneys general signed on to the 50-page Ameriquest settlement, the national implications are obvious, and the industry must pay attention to its provisions.

Indeed, New York State Banking Superintendent Diana Taylor has expressed her expectation that "the rest of the mortgage industry ... use [the settlement] as a model for doing business."

In addition, Iowa Attorney General Tom Miller, who heads a multistate predatory-lending task force, said this past September that "the rest of the industry should follow the core concepts of the Ameriquest settlement. If they don't, they'll probably end up as the next multistate [task-force target]."

The settlement provides for a host of new disclosures and other requirements. One of the most-important provisions requires that the lender use scripted language to disclose loan terms to borrowers verbally as soon as they have agreed to submit a loan proposal for processing. The script dictated by the settlement covers disclosures of interest-rate terms, discount points for fixed-rate mortgages, adjustable-rate-mortgage terms and prepayment-penalty terms.

In addition to the new oral disclosure and to the existing disclosures mandated by RESPA, TILA and other state and federal statutes, Ameriquest is required to give borrowers a one-page

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## The Case for National Reform

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written disclosure. This new written disclosure must be the first document presented to borrowers at closing.

Other parts of the agreement also go beyond any current legal requirements. For instance, if the loan is based on a stated income, borrowers must sign a new certification at closing to verify the income's accuracy. In addition, after the loan has closed, Ameriquest must attempt to contact the borrowers and review the loan terms yet again. The agreement contains a number of other requirements concerning prepayment penalties, appraisals, closing agents and refinancing, among others.

The tenor of the settlement reinforces the fact that the volume of loan documentation necessitated by the layers of regulations for brokers and lenders is simply too great for the typical borrower to grasp. But the answer is not to require the industry to provide even more oral and written disclosures that may further overwhelm borrowers. Rather, the answer is to implement a simple, uniform and comprehensive national regulatory system that protects borrowers but that does not burden the mortgage industry with redundant, nebulous rules.

Finally, the settlement bars the lender from making any loan that doesn't meet the vague standard of "benefit[ing] the borrower." Traditionally, mortgages have been arm's-length agreements in which both parties negotiate for terms. That free-market approach gave providers tremendous incentive to compete for consumers' business and to offer lower rates and innovative payment structures.

Following the Ameriquest settlement, mortgage companies face being required to provide the same interest rates and loan terms to similar consumers with little, if any, negotiation. The settlement's interest in achieving benefits for consumers is laudable, but this straight-jacket approach seems a substantial intrusion that will only handicap lenders, brokers and borrowers when they make a deal.

### The perils of overregulation

Although high-profile settlements have been negotiated with national mortgage companies, their terms likely will directly impact the origination activities of those on the front lines — mortgage brokers and loan officers. Many of the business practices addressed in the settlements concern loan origination.

Thus, a recent report by the National Association of Mortgage Brokers (NAMB) is particularly

troubling. It suggests that state attorneys general, financial regulators and district attorneys are primed to direct their litigation muscle at the mortgage-broker industry.

On the heels of the Ameriquest settlement, NAMB anticipates that brokers can expect attention to focus on three areas: 1. the need for additional disclosures; 2. the treatment of similarly situated borrowers; and 3. problems associated with compensation and "upselling." If this wave of regulatory investigation and litigation is indeed on the horizon, it is possible that an effort at pre-emptive compliance by the industry might allow it to dodge that bullet.

A trend toward greater oversight and regulation of mortgage practice may be clear, but the result is not easy to appraise. In some cases, the mortgage industry warrants corrective action in response to questionable lending practices. In 2003, there were 9,539 suspicious-activity-report fraud filings; in 2004, there were 18,391.

On the other hand, as the response to Georgia's legislation suggests, some regulatory incursions backfire. This constrains the industry as companies shutter their operations, eliminate services to populations in particular need and move their business elsewhere.

Additionally, the sheer volume, complexity and weight of the many layers of regulatory oversight from federal, state and local agencies, in addition to case-law precedents and investigation settlements, can make for a daunting business environment. Many mortgage professionals throw up their hands in frustration.

But inaction poses its own threats. When usury laws were directed at the credit card market, competition on interest rates evaporated, and companies competed on other, less-efficient margins. Consumer credit card products naturally constricted.

Another example: Expanded insurance regulation and liability in Louisiana in the mid-1980s led to bankruptcy for many insurers and an exodus from the state for others. In Florida, an effort to reverse a similar exodus through enactment of various initiatives has sought to recover insurance carriers driven out of the state by overregulation.

In like fashion, NAMB observed in a 2005 release that "the resulting patchwork of [state] regulations has driven many mortgage lenders away from [certain] markets to the detriment of consumers."

### Industry response

There have been positive developments, though. Advocacy on the part of the American

Association of Residential Mortgage Regulators, the Conference of State Bank Supervisors, NAMB and the Mortgage Bankers Association (MBA), among others, seeks to prevent and to reverse these trends by calling for national standards and a uniform regulatory scheme.

NAMB has applauded bipartisan congressional efforts to enact the Responsible Lending Act, which seeks to create comprehensive, uniform lending standards for the country. The MBA has likewise endorsed the bill as an appropriate response to the "proliferation of well-intended though overbroad state regulations that threaten the availability of credit to consumers."

In addition, HUD proposed changes to standard mortgage forms in 2005 that should achieve greater simplicity, transparency and cost certainty for consumers. In support of that gesture, NAMB worked toward developing a revised good-faith-estimate form to meet borrowers' needs.

Government and industry commentators agree that federal standards would simplify overly complex compliance obligations that currently diminish competition, constrain services and invite wasteful litigation. Streamlining the regulatory process nationwide can translate into lower administrative costs for the industry and better rates for consumers.

Some believe the best solution on the table now is the kind of national system advocated by the bank-supervisor conference and mortgage-regulator association that is reflected in part in the Responsible Lending Act. This system would streamline licensing, increase industry accountability, centralize redundant state-agency operations and increase consumer protection.

Whether that bill or another succeeds, it's imperative to achieve consistent, simple and uniform standards nationwide. This will not only restore sanity to the regulatory landscape imposed on the mortgage industry but will also achieve greater consumer protection and confidence in the housing market, which plays such a critical role in the national economy. ❗

## Other Investigations

The Ameriquest decision is not the only settlement that could affect how brokers do business. Pending investigations or litigation are under way in:

- Arizona
- Arkansas
- California
- Idaho
- Iowa
- Mississippi
- New Mexico
- New York
- Oregon
- Pennsylvania

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