ENFORCEMENT TRENDS: THE STATES STEP UP

MORTGAGE PRICING UNDER SCRUTINY • RETURN OF THE WHOLESALE MORTGAGE BROKER
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With more than 150 lawyers in Washington, D.C., Los Angeles, San Francisco, New York, Chicago, and London, Buckley Sandler LLP offers premier enforcement, litigation, compliance, regulatory and transactional services to financial services institutions, as well as leading and early stage companies, joint ventures, private equity funds and individual clients throughout the world. “The best at what they do in the country.” (Chambers USA)
The new leadership at the Consumer Financial Protection Bureau has explicitly stated that it expects to pursue fewer enforcement actions than it has in the past. While the anticipated reduction in CFPB enforcement activity may cause some companies to feel a sense of relief, there may be less cause to celebrate than we might think. As the CFPB curtails enforcement activity, the states have already begun ramping up their efforts to close the gap with an open invitation to do so by the bureau. Indeed, Acting Director Mick Mulvaney publicly stated in February 2018 that he would depend heavily on state attorneys general to enforce consumer protection laws.\(^1\)

States and their attorneys general are generally well-positioned and motivated to take the reins in pursuing consumer protection matters involving financial service companies and third-party service providers, having worked closely with the CFPB and other federal enforcement agencies under the Obama administration and in multistate commissions following the financial crisis. After witnessing and participating in an unprecedented period of consumer protection enforcement on a path paved by the CFPB — a path of “aggressively pushing the envelope” that Acting Director Mick Mulvaney has explicitly rejected\(^2\) — state agencies now have a road map to follow. In addition, attorneys general in Democratic-leaning states face considerable political pressure to maintain active enforcement dockets, both to demonstrate their commitment to defend consumers against perceived corporate overreach and as a way to resist publicly the Trump administration’s efforts to pull back on burdensome regulations and aggressive enforcement strategies. Election-year politics only heighten these pressures, setting off a potential firestorm of state-specific enforcement agendas that could force companies to

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operate in perpetual defense mode through seriatim or concurrent state-level inquiries and investigations.

Such enforcement initiatives have not been reserved for attorneys general — or even states for that matter. Numerous consumer protection investigations have been launched over the past several months by state agencies other than attorneys general in addition to municipal agencies with consumer protection investigative powers.iii

**RECENT STATE ATTORNEY GENERAL EFFORTS**

State laws prohibiting unfair and deceptive acts and practices are in many instances rooted in established case law interpreting Section 5 of the Federal Trade Commission Act, which prohibits unfair or deceptive acts or practices.iv While those laws generally lack the abusiveness standard that the Dodd-Frank Act established under its prohibition of unfair, deceptive, or abusive acts and practices, they pack the same punch insofar as policies and practices that are permitted by a product-specific statute or regulation, e.g. state mortgage servicing regulations, may still be deemed a UDAP violation.

Adding fuel to the fire, states have a history of coordinating with each other and federal regulators on enforcement initiatives. Perhaps the most notable post-financial crisis example is the 2012 joint action targeting the nation’s five largest mortgage servicers.v In that sweeping settlement, the federal government and 49 states coordinated with each other to provide a series of protections to, and financial recompense for, borrowers whose loans were subject to certain origination, servicing, and foreclosure practices.

Emboldened by the aggressive posture of the CFPB, state attorneys general have set their sights on broader issues, taking aim at an array of products in any given household financial portfolio.

State enforcement activity has only increased since the multistate mortgage servicing settlement. State attorneys general have worked with the CFPB, other federal agencies, and each other under their respective UDAP, UDAAP, and other consumer protection enforcement authority to take on issues either deemed to be a direct fallout of the financial crisis, or resulting from the perceived laxity in consumer protection regulation, supervision, and enforcement that led to it. Areas of ongoing scrutiny include predatory and discriminatory lending, deceptive advertising, errors in credit reporting, and abusive debt collection practices. Emboldened by the aggressive posture of the CFPB prior to the current administration, state attorneys general have set their sights on broader issues than traditional mortgage lending.

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iii See, e.g., Press Release, Pennsylvania Treasury, Treasurer Torsella Opens Inquiry into Findings of Lending Disparities at Financial Institutions Handling PA Funds (Feb. 21, 2018), [link](http://www.patreasury.gov/newsroom/archive/2018/02-21-Lending-Disparities.html) (announcing investigation by Pennsylvania’s State Treasury Office into alleged discriminatory mortgage lending practices); Phillip Jackson, City Council Action on Home Lending Bias is Urged, Philadelphia Tribune (Feb. 23, 2018), [link](http://www.phillytrib.com/news/city-council-action-on-home-lending-bias-urged/article_7afe25c4-237e-5236-b35f-d9c2b1b118ef.html) (Philadelphia City Council calls for hearings to investigate racial disparities in home lending); N.Y. Dep’t Fin. Servs., Statement by DFS Superintendent Maria T. Vullo Regarding CFPB’s Troublesome Policy Shift Away from Consumer Protection (Jan. 25, 2018), [link](https://www.dfs.ny.gov/about/statements/s1801251.htm) (statement from New York Department of Financial Services Superintendent reiterating that agency’s commitment to lead efforts to fill federal regulatory voids).


v See Press Release, U.S. Dept’ of Justice, $25 Billion Mortgage Servicing Agreement Filed In Federal Court (Mar. 12, 2012), [link](https://d9klfgibhecq.cloudfront.net/Settlement-USDOJ-FILING-news-release.pdf) (“The Justice Department, the Department of Housing and Urban Development [HUD] and 49 state attorneys general announced today the filing of their landmark $25 billion agreement with the nation’s five largest mortgage servicers to address mortgage loan servicing and foreclosure abuses.”).
and servicing concerns, taking aim at an array of products in any given household financial portfolio, from payday and auto finance, to credit card, debt collection, and student loan practices. States have also pursued unlawful practices outside the traditional ambit of financial services companies and expanded their efforts to include the wireless telephone industry and for-profit colleges.

However, unlike the CFPB, the jurisdiction of which is limited to certain enumerated federal laws and covered entities, states have assumed a wider reach. Health care, social media, manufacturing, and privacy protections, for example, are areas that can fall within the scope of state UDAP and anti-discrimination laws. Broadly-constructed state consumer protection laws enable state attorneys general to mobilize around a wider range of products, services, and industries than the CFPB or prudential banking regulators. And because state attorneys general are popularly elected in the overwhelming majority of states and U.S. territories, their enforcement agendas can be tailored to the interests of constituents, influential advocacy groups, and political parties. State elected officials can visibly demonstrate they are tough on consumer protection abuse by swiftly engaging in headline-grabbing enforcement matters that carry hefty price tags for restitution and penalties. The recent string of massive data breaches is among the most notable examples of rapid state attorney general response and intervention.

THE FUTURE OF STATE ATTORNEY GENERAL ENFORCEMENT

As the CFPB’s enforcement role diminishes, states are poised to expand their reach not only through their own laws, but also through federal laws. Some states, like Pennsylvania, Maryland, and New Jersey, have announced the creation of special offices dedicated to consumer protection. Others, like New York, Massachusetts, and California, have unequivocally stated that they stand ready to fill any void left by a weakening of the CFPB. In fact, the attorneys general of 17 states signed a December 2017 letter to President Trump, drafted by New York Attorney General Eric Schneiderman, expressing their support for an independent CFPB and reiterating their commitment to enforce federal and state consumer protection laws. They wrote that they would “redouble [their] efforts at the state level” if “incoming CFPB leadership prevents the agency’s professional staff from aggressively pursuing consumer abuse and financial misconduct.”

They have the power to follow through on that promise. Though they are nominally the chief law enforcement officers


\[ \text{See Dodd-Frank Act, 12 U.S.C. §§ 5552(a)(1).} \]
for their state, attorneys general can, in certain circumstances, enforce federal laws. The Dodd-Frank Act specifically grants states the authority to bring a civil action to enforce certain provisions of the act, including its UDAAP prohibition. Indeed, several states have already relied on this provision to bring suits against financial service providers. In addition, many federal consumer protection laws expressly grant states enforcement authority, affording them a bigger toolbox to challenge perceived misconduct. These measures expand the states’ reach and give them leverage to levy the larger fines associated with federal statutes.

Cooperation remains a tried-and-true enforcement method. With increasing frequency, states align to conduct parallel investigations, or coordinate joint investigations led by one state or a number of states through a committee. Given enough interested states, cooperation is akin to a federal action, with the ability to combine resources and put greater pressure on an enforcement target. It is a formidable thing for an institution to be in the crosshairs of a single federal agency with ample resources, but being in the sights of a collection of separate but coordinated states can be equally, if not more, challenging.

The knowledge and experience that the CFPB has developed in recent years may literally relocate to state offices. CFPB enforcement staff have already begun to depart for other agencies or organizations that offer a more vigorous enforcement agenda — a trend that seems likely to continue if they find themselves with little to do under the bureau’s new leadership. A natural home for outgoing CFPB staff is in consumer protection divisions at state attorneys general offices, where they can continue to investigate the same issues they did at the bureau.

HOW TO PREPARE NOW

There are things your company can do now to prepare for increased scrutiny from state enforcement authorities.

- First, do not let your first interaction with the office of your state attorney general be a response to a subpoena. Rather, seek out opportunities to introduce the company to the attorney general or front office staff and educate them about your business. Opening the line of communication can be beneficial to both parties and provide opportunities to address concerns before a formal inquiry commences.
- Second, do not back off compliance efforts. Even if the CFPB were to cease enforcement efforts tomorrow, for the reasons discussed above, the states stand ready to step into its shoes on enforcement, not to mention the fact that licensing authorities, banking regulators, and the CFPB still examine covered institutions for the integrity of their compliance management systems. Moreover, the lifecycle of an enforcement matter is long, and nobody can predict what a state or federal agency might find worth investigating in the years to come — actions with heightened

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compliance risk today can cause enforcement trouble in the future. Stay the course on compliance regimes put in place post-financial crisis, as those who revert to looser standards will be easier targets when the next enforcement wave inevitably cycles back.

- Finally, monitor activities of interest in your industry and your state. If business practices spark consumer complaints and pique media interest, assume your state’s attorney general’s interest is piqued, too. Proactive efforts to identify and address potential issues before an investigation begins are meaningful from a risk mitigation standpoint, but are also a best practice from a customer service perspective.
Notwithstanding the dramatic expansion of consumer financial protection regulation in the wake of the financial crisis and the Dodd-Frank Act, most would still agree with the general principle that markets, not regulators, should determine the prices that consumers pay for loans. However, recent federal and state enforcement actions against mortgage lenders indicate that, even if regulators are not setting “the right price” for loans, they are increasingly willing to declare certain prices “wrong.” While there are steps that mortgage lenders can take to minimize the risk of enforcement actions, the trend is troubling because it suggests that regulators will intervene even when lenders apply loan pricing in a nondiscriminatory manner and accurately disclose such pricing to consumers.

THE ROLE OF DISCOUNT POINTS AND LENDER CREDITS IN MORTGAGE PRICING

While mortgage loan pricing is too complex to discuss in any real depth here, the key concept for purposes of this discussion is that mortgage lenders typically offer consumers a range of interest rates from which to choose, each of which is generally coupled with either the consumer or the lender making a payment. If the consumer selects an interest rate at the lower end of the range, the consumer will make an upfront payment of “discount points” to the lender. If the consumer selects an interest rate at the higher end of the range, the lender will make an upfront payment of “lender credits” to reduce the costs the consumer must pay to close the loan (including for taxes, government recording charges, and title fees).

Each mortgage lender sets its prices by determining the combinations of rates, points, and
credits that it will offer to consumers. These pricing decisions are informed by a number of factors, including the expected loan value if sold on the secondary market, the lender’s costs to originate the loan (including loan officer or broker compensation), and the lender’s need to make a profit while offering competitive terms.

To our knowledge, no federal or state law prohibits a lender from offering different prices to two similarly situated applicants, so long as the lender does not discriminate on a prohibited basis (e.g., based on the applicant’s race, sex, national origin, or religion). For example, a lender can offer a 30-year mortgage at 4 percent with two points to Applicant A and that same loan at 4.5 percent with two points to Applicant B, so long as the lender does not engage in impermissible discrimination.

THE APPLICATION OF UDAAP TO MORTGAGE PRICING

Regulators are increasingly scrutinizing mortgage pricing and using their authority to prohibit unfair, deceptive, or abusive acts or practices to cite lenders for failing to give consumers what, in the regulators’ view, is the “full benefit” of discount points or lender credits.

In November 2017, the Federal Reserve Board entered into a consent order with a bank to resolve claims that, between January 2011 and March 2015, “many borrowers did not receive a benefit or the full benefit associated with paying Discount Points.”

Significantly, the Fed stated that, even though the bank provided disclosures to consumers that “gave an accurate quantitative picture of the loans’ costs,” the disclosures “mischaracterized the nature of those costs because they indicated that a specified portion of the fees paid at closing were being used to purchase a lower, discounted rate, but sometimes that was not accurate.”

The Fed further stated that the loan disclosures, despite being accurate, misrepresented the rate and discount points because a “borrower acting reasonably under the circumstances could have concluded based on the disclosures that the interest rate he or she was purchasing with the Discount Points was lower than what [the bank] otherwise would make available to that borrower without the payment of Discount Points.”

The New York Department of Financial Services took a similar position in a different matter. Specifically, in a November 2016 consent order, it found that a state-licensed lender “collected fees from borrowers that were charged in exchange for a reduced interest rate. However, these files failed to contain documentation establishing whether such borrowers actually received the promised discounted rates, creating

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When a lender cannot demonstrate that it applied a consistent, documented pricing methodology, regulators may assume that the lender’s pricing practices are unfair.

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1 In the Matter of Peoples Bank, Federal Reserve Docket No. 17-041-B-SM, p. 2 (Nov. 28, 2017), https://www.federalreserve.gov/newsevents/pressreleases/files/enf20171128a1.pdf (“Many borrowers who paid Discount Points did not actually receive a reduced interest rate or received a rate that was not reduced commensurate with the price paid for the Discount Points.”). While this appears to be the first federal enforcement action of its kind, it is worth noting that the Fed previously raised concerns about “unearned discount points” in a 2012 Consumer Compliance Outlook article titled “Compliance Risks for Unearned Discount Points.” See Kelly Walsh, Compliance Risks for Unearned Discount Points, Consumer Compliance Outlook (3d. Quarter 2012), https://consumercomplianceoutlook.org/2012/third-quarter/compliance-risks-for-unearned-discount-points/.

2 Peoples Bank, supra note.

3 Id.
the possibility that [the lender] may have charged borrowers for services it did not provide.\textsuperscript{iv}

The NYDFS also took action against another state-licensed lender with respect to lender credits. In August 2017, the agency entered into a consent order based on a finding that:

Where borrowers obtained from [the lender] a credit to cover estimated closing costs by agreeing to a higher interest rate (a “lender credit”) and where the final closing costs were lower than such estimated costs (resulting in a “surplus lender credit”), [the lender] did not adjust down the interest rate, reduce the principal balance of the loan, reduce the down-payment (if applicable), provide a cash refund, or pursue any other means of refunding the surplus to the borrower.\textsuperscript{v}

The NYDFS concluded that the lender violated New York law by:

selling lender credits to borrowers, yet (1) not disclosing the credit purchased on the Good Faith Estimate, (2) not disclosing to the borrowers that [the lender] would keep the balance of the credit when the closing costs were below the amount of the credit, and/or (3) not disclosing the amount of surplus lender credit[].\textsuperscript{vi}

In each of these actions, the regulators noted the lender’s failure to maintain written policies, rate sheets, or other records documenting the relationship between interest rates and discount points or lender credits.

**THE APPLICATION OF OTHER FEDERAL REQUIREMENTS TO MORTGAGE PRICING**

In nonpublic examinations, we have observed an increased interest — particularly by the Consumer Financial Protection Bureau — in whether (i) lender credits were properly disclosed on the TILA-RESPA Integrated Disclosure forms, and (ii) closing costs paid using lender credits were finance charges that must be included in the annual percentage rate and points-and-fees tests for qualified mortgage and high-cost loan status. As with the UDAAP actions discussed above, a lack of documentation can present challenges in demonstrating to regulators that lender credits are properly categorized because these determinations are generally governed by “the terms of the legal obligation” between the lender and the consumer.\textsuperscript{vii}

The actions discussed above indicate that, separate and apart from fair lending testing, regulators will scrutinize how mortgage lenders set interest rates in relation to discount points and lender credits. These

\textsuperscript{iv} In the Matter of PHH Mortg. Corp. and PHH Home Loans, Consent Order, p. 7-8 (Nov. 9, 2016), http://www.dfs.ny.gov/about/ea/ea161109.pdf. Furthermore, in a September 2013 consent order, the NYDFS found that another state licensed lender “collect[ed] loan discount fees to reduce the initial rate, but fail[ed] to give borrowers the discounted interest rate associated with such fees.” In the Matter of Prospect Lending, Consent Order, p. 2 (Sept. 10, 2013), http://www.dfs.ny.gov/about/ea/ea130910b.pdf. While New York law imposes a number of requirements specific to discount points, these consent orders do not make clear the extent to which the NYDFS based its findings on those specific requirements as opposed to general disclosure requirements and prohibitions on misrepresentations and other UDAAPs.


\textsuperscript{vi} Truth in Lending Act, Regulation Z, 12 C.F.R. § 1026.17(c)(1); see, e.g., Supplement I to Part 1026, comment 4(a)-2 (“Charges absorbed by the creditor as a cost of doing business are not finance charges, even though the creditor may take such costs into consideration in determining the interest rate to be charged or the cash price of the property or service sold. However, if the creditor separately imposes a charge on the consumer to cover certain costs, the charge is a finance charge if it otherwise meets the definition.”); Supplement I to Part 1026, comment 37(g)(6)(ii)-2 (“The creditor should ensure that the lender credit disclosed on the Loan Estimate is sufficient to cover the estimated costs the creditor represented to the consumer as not being required to be paid by the consumer at consummation, regardless of whether such representations pertained to specific items.”).
actions further indicate that, when a lender cannot demonstrate that it applied a consistent, documented pricing methodology, regulators may assume that the lender’s pricing practices are unfair, deceptive, or abusive, even when consumers received the promised pricing and disclosures were accurate.

Lenders can minimize this risk by adopting policies and procedures governing pricing, applying those policies and procedures consistently when communicating with consumers, and documenting pricing decisions on a loan-level basis. However, these controls do not provide a safe harbor and may pose new challenges from a business perspective. Just as the combination of fair lending laws and loan originator compensation rules have made it more difficult to give loan-level pricing discretion to loan officers, these controls may make it more difficult to give branch managers discretion to meet the pricing pressures in their local markets. Finally, the enforcement actions discussed above leave open the possibility that regulators will seek to delve even deeper into loan pricing in the future.

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We get it: The simple mention of climate change invokes a visceral reaction from believers and skeptics alike. Rest assured; we are not trying to achieve consensus regarding the planet’s future through this article.

We do, however, want lenders and servicers to take a fresh look at some uncontroversial facts to ensure they are approaching their flood risks with eyes wide open:

- Flooding is currently the most common and expensive U.S. natural disaster\(^i\)
- Companies that violate the Flood Disaster Protection Act, which generally requires mortgaged properties in certain areas to have flood insurance, face greater potential liability than ever before\(^ii\)
- Floods increase defaults and decrease collateral value. A recent study of December 2017 mortgage data found that nearly 143,000 loans were 90 days or more delinquent because of hurricanes Harvey and Irma — about 20 percent of all severely delinquent loans nationwide.\(^iii\)

**IS MY COMPANY COMPLYING WITH ALL APPLICABLE LEGAL REQUIREMENTS?**

Financial institutions are legally required to comply with myriad requirements related to flood insurance, including:

- The purchase of mandatory flood insurance under the FDPA
- Lender-placed insurance (LPI) requirements under the Real Estate Settlement Procedures Act
- Flood insurance requirements of the Federal Housing Administration, U.S. Department of Veterans Affairs, U.S. Department of Agriculture, Fannie Mae, Freddie Mac, private investors, or state-specific programs

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\(^iii\) Black Knight, Black Knight’s First Look at December 2017 Mortgage Data (Jan. 23, 2018), [http://www.bkfs.com/CorporateInformation/NewsRoom/Pages/20180123.aspx](http://www.bkfs.com/CorporateInformation/NewsRoom/Pages/20180123.aspx).
Applicability of these requirements varies. For example, the FDPA applies only to federally-regulated financial institutions and requires flood insurance only on loans secured by buildings located in special flood hazard areas (SFHAs) in communities that participate in the National Flood Insurance Program. The FDPA applies regardless of the purpose of the loan or the use of the property. In contrast, RESPA's LPI requirements apply generally to servicers, but only if they obtain LPI not required by the FDPA on properties secured by closed-end residential mortgage loans.

The first step for companies in addressing these requirements is to determine which program requirements apply, and then ensure that they have addressed them appropriately. This may involve:

- Cataloging all applicable legal requirements
- Implementing policies, procedures, and job aids to ensure compliance
- Tracking updates to the law, regulatory expectations, and industry best practices
- Monitoring and testing compliance (e.g., conducting periodic loan-file reviews)
- Ensuring proper reporting of violations, as well as prompt and effective corrective action
- Providing ongoing training to employees and agents
- Implementing sufficient vendor-management controls

This can be a surprisingly complex undertaking. The FDPA is highly technical and it is not uncommon for examiners to interpret the requirements differently. Further, a single financial institution adopting varying compliance approaches across departments can invite regulatory scrutiny. In fact, FDPA violations are a common basis for civil money penalties. Therefore, many financial institutions opt to centralize their flood insurance compliance function.

Failure to comply with relevant requirements may result in examination findings, costly look-backs, enforcement actions, and civil money penalties for “pattern or practice” violations, which are larger than they were in the past. Historically, some in the industry regarded civil money penalties under the FDPA as insignificant, but that changed in 2012 when the per-violation penalty increased to $2,000 and the annual cap was removed. Several banks have subsequently received six-figure penalties, and one bank recently received a $1.5 million penalty.

Noncompliance can also result in litigation and reputational risk. Recent cases involving allegations of excessive coverage requirements and LPI kickbacks have settled for millions of dollars. And, of course, there is significant exposure to actual flood losses if a financial institution fails to require legally mandated coverage and flooding occurs.

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*Real Estate Settlement Procedures Act, 12 U.S.C. § 2605(f).*

Given these considerations, companies may wish to review their policies, procedures, and practices to ensure accurate and full implementation of the various legal requirements.

**DOES MY COMPANY’S PORTFOLIO INCLUDE CONCENTRATIONS OF RISK THAT SHOULD BE ADDRESSED?**

Even if a financial institution correctly implements the “black letter” flood insurance requirements, it may still be exposed to significant risk. For example:

- The FDPA only requires flood insurance in SFHAs, but more than 20 percent of claims under the NFIP come from properties outside an SFHA, and one estimate found that more than 50 percent of Hurricane Harvey’s flood damage occurred outside an SFHA.
- NFIP caps coverage at $250,000 for most residential buildings and $500,000 for nonresidential buildings, and limits payouts to the “actual cash value” for many properties, but the cost to rebuild properties or repay loans often significantly exceeds these caps.
- Lenders may still be responsible for payments to securityholders on loans that are in default or forbearance, which can be a significant financial burden.
- When mortgage insurance is available following foreclosure, uninsured flood damage may limit the value of the lender’s mortgage insurance claim.
- A property that does not flood can still be affected by flooding in the vicinity that impacts the borrower’s ability to pay (e.g., if the borrower’s income is affected) and the value of the property (e.g., if the flooding decreases the value of neighboring properties).

As a result, companies in the mortgage market may elect to identify and measure their concentrations of flood-related risk to ensure their exposure is acceptable. Risk assessments may include:

- Estimating the risk of flooding for properties located both inside and outside SFHAs using tools beyond the Federal Emergency Management Agency’s flood maps, because FEMA’s flood maps have been subject to criticism as outdated or inaccurate.
- Determining the extent to which the entity’s interest in properties may be underinsured (e.g., because of NFIP coverage caps or the FHA’s mortgage-insurance limitations).
- Assessing the potential impact of a community flooding on the entity’s financial position (e.g., due to a high concentration of loans).

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vii National Flood Insurance Act of 1968 and Flood Disaster Protection Act of 1973, 42 U.S.C. § 4012a(b)(1). SFHAs are areas determined to have at least a one percent chance of flooding in any given year. See e.g., Loans in Areas Having Special Flood Hazards, 12 C.F.R. § 339.2.


in the community or the need to pay security holders while loans are in forbearance or default)

Entities that discover they are subject to unacceptable flood risks can evaluate various options for reducing risks. These include enhancing communications with borrowers about their flood risks, requiring coverage in circumstances in which coverage is not legally required, adjusting underwriting or loan terms in higher-risk areas, divesting certain loans, and offering owners of at-risk properties loans to complete flood-mitigation activities.

If these policy changes are made, they must be carefully managed to avoid unintended consequences, which include fair lending or UDAAP risk, state-law limitations or prohibitions, or other legal risks.

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The prevalence of wholesale mortgage brokers has fluctuated dramatically in the past two decades, peaking in the mid-to-late 2000s due to high homebuyer demand and a comparatively lax regulatory environment, and crashing with the housing market and subsequent financial crisis. The massive overhaul of the financial system, including the Dodd-Frank Act, imposed costly and complicated new requirements on an industry that was already struggling. Among these requirements were loan originator compensation rules that eliminated yield spread premiums, the lifeblood of brokers. The changes came as many banks were already shifting their focus from wholesale channels to direct lending. These forces drove many brokers out of business and, for some, fueled an exodus to a mortgage banker model — with former brokers either becoming correspondent lenders (so-called “mini-correspondents”) or joining forces with established mortgage banks as branches. However, in the past few years, wholesale mortgage brokers have re-emerged as independent players in the mortgage loan market because:

- Brokers have become accustomed to the laws and are able to more easily navigate them
- Alternative methods for home financing have rebounded with the housing market
- Correspondent and retail lenders typically make less money, offer fewer products, and have less regulatory flexibility than the wholesale model offers

The Trump administration has taken a different approach than the Obama administration in the supervision and regulation of...
the financial services industry — an approach best articulated recently by Consumer Financial Protection Bureau leadership in flatly rejecting what it said was the “push the envelope” governing philosophy of prior leadership. However, states continue to have enforcement authority over mortgage brokers, and some state attorneys general have said they will fill any federal enforcement gap. That should compel lenders and brokers to maintain strong compliance environments. Although lenders approaching this market with strong vendor management programs and high broker standards may initially feel they are at a competitive disadvantage, they should be in a stronger position in the long run, given current and future enforcement, regulatory, and reputational risks.

“MORTGAGE BROKER” DEFINED

Typically, a mortgage broker is an entity or individual that acts as an intermediary between a consumer and a mortgage lender in connection with a mortgage loan. Brokers may perform a number of activities in connection with origination, including advertising, taking applications, checking credit, negotiating terms, and arranging for signatures on documents. Traditionally, mortgage brokers offer loans from multiple lenders and advise borrowers of their options, but it is increasingly common for lenders to get referrals directly from nontraditional sources. For example, many securities broker-dealers partner with lenders, and many lead generators are incorporating mortgage brokerage in their business models.

A mortgage broker must actually furnish goods, facilities, or services to be paid, and total compensation must be reasonably related to the fair market value of the goods, facilities, or services provided.\(^1\)

In 1999, the U.S. Department of Housing and Urban Development published the Real Estate Settlement Procedures Act Statement of Policy 1999-1, which advises that taking an application and conducting at least five additional services (other than only five “counseling-type” activities) justifies mortgage broker compensation.\(^2\) While the CFPB now maintains rulemaking and enforcement authority over the RESPA, the HUD statement of policy remains binding in the absence of a CFPB regulation retracting it.\(^3\)

The definition of “mortgage broker” varies from state to state. In some states, the definition is modeled after the definition of “loan originator” in the Model S.A.F.E. Mortgage Licensing Act published by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators.\(^4\) The Model SAFE Act provides that a mortgage broker is an individual who, for compensation or gain, takes a residential mortgage loan application or offers or negotiates residential mortgage loan terms. Other states have added the “soliciting” of mortgage loans as a licensing trigger.

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\(^1\) See Real Estate Settlement Procedures Act, 12 U.S.C. § 2607(c).


\(^3\) Real Estate Settlement Procedures Act’s Regulation X, 12 C.F.R. § 1024.4(a)(1)(ii); Statement of Policy 1999-1, 64 Federal Register at 10084 (“The Department hereby states its position on the legality of payments by lenders to mortgage brokers under the Real Estate Settlement Procedures Act (12 U.S.C. 2601 et seq.) (RESPA) and its implementing regulations at 24 C.F.R. part 3500 (Regulation X). The Statement of Policy is issued pursuant to Section 19(a) of RESPA (12 U.S.C. 2617(a)) and 24 C.F.R. 3500.4(a)(1)(ii)

(among other triggers), such that nearly any activity triggers licensure. Thus, industry participants should carefully consider each state’s definition of “mortgage broker” and ensure that they comply with applicable law.

**VENDOR MANAGEMENT CONSIDERATIONS**

The CFPB and other regulators are increasingly inclined to hold mortgage lenders accountable for their mortgage brokers’ misconduct. To lower their risk, lenders may require brokers to fulfill certain requirements during onboarding, and submit to their regular oversight and inquiries. In addition to requiring certain representations and warranties in their mortgage broker agreements, lenders may seek to ensure that their brokers understand and comply with applicable legal requirements. This may include lender review of brokers’ policies and procedures, compensation plans, training materials, licensing postures, and compliance-management systems.

**MORTGAGE BROKER REQUIREMENTS**

Mortgage brokers are subject to many federal and state law requirements, including:

- **Licensing/registration.** Nonbanks that engage in mortgage broker activities and their loan originator employees require state licenses. Currently, every state and the District of Columbia requires licensure at the company, branch, and individual (i.e., mortgage loan originator) levels, unless an exception applies. Most states have modeled their licensing laws after the federal Secure and Fair Enforcement for Mortgage Licensing Act of 2008 or the Model SAFE Act. For companies, the application typically requires submission of formation documents, financial statements, a surety bond, and control person information. For individuals, the license requires completing prelicense education, passing an examination, and submitting to background credit checks. Mortgage broker licensees are subject to a number of state law requirements, including advertising, disclosure, fee, and various reporting requirements.

  Employees of depository institutions and their federally regulated subsidiaries who engage in mortgage broker activities are exempt from state licensing schemes, though they must be federally registered through the Nationwide Multistate Licensing System & Registry. Federal registration is much easier than the state licensing. For example, state license applicants must complete at least 20 hours of prelicense education and pass an examination, but federal registration requires neither. Many mortgage brokers chose to work for depository institutions following the enactment of the SAFE Act in 2008 principally because of these differences.
Truth in Lending Act. The Truth in Lending Act includes a number of requirements that apply to mortgage brokers. For example, the TILA Loan Originator Rule limits broker compensation, such that brokers generally cannot be compensated based on any term other than loan amount (with certain exceptions for bonuses, retirement plans, and other compensation plans that are based on mortgage-related profits). Many former brokerages that became lender “branches” following the financial crisis are defecting to again become brokerages to avail themselves of various mortgage lenders’ loan originator compensation plans. The LO Rule’s anti-steering prohibitions are designed to prevent mortgage brokers from directing a consumer to a specific lender simply because the mortgage broker would receive higher compensation from the lender. However, a mortgage broker would not run afoul of the anti-steering prohibition so long as placement of a loan with a particular lender does not result in the consumer receiving less advantageous loan terms, compared with other loans offered through the broker. A mortgage broker can avoid the anti-steering prohibitions by presenting options the consumer will likely qualify for from at least three creditors with which the broker regularly does business, for each type of loan the consumer expresses an interest in, and including options with (i) the lowest interest rate; (ii) the lowest interest rate on a loan without certain specified features (negative amortization, balloon payment, etc.); and (iii) the lowest total dollar amount of discount points, origination points or origination fees (with certain variations). Having a variety of compensation plans from which to choose helps mortgage brokers maximize their compensation.

Also, under the LO Rule, individual mortgage brokers who are not state-licensed (and who are not required to be state-licensed) must be “qualified” (i.e., they must pass background and credit checks, as well as complete periodic training covering certain federal and state law requirements).

Another example is the TILA/RESPA Integrated Disclosures Rule, commonly referred to as TRID, which requires the creditor or broker to deliver or mail a loan estimate no later than the third business day after receiving the consumer’s application. Although a mortgage broker can satisfy the creditor’s obligation to provide a loan estimate, the creditor remains legally responsible for errors or defects, and is expected to maintain communication with the broker to ensure that the estimate and its delivery satisfy requirements. Brokers providing the estimate must comply with the rule’s three-year record retention requirement.

Loans insured by the Federal Housing Administration. A mortgage broker not approved by the FHA may nonetheless originate an FHA-insured loan as long as it is sponsored by an FHA-approved

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\(^1\) Truth in Lending Act’s Regulation Z, 12 C.F.R. § 1026.36(d).
\(^2\) Truth in Lending Act’s Regulation Z, 12 C.F.R. § 1026.36(e)(1)(i); CFPB Commentary — Supplement I to Part 1026, comment 36(e)(1)-3.
\(^3\) See id. at (f).
mortgagee with direct endorsement authority. These third-party originators, or TPOs, may not close loans in their own names, but may originate loans underwritten by their sponsors. Sponsors are required to register their TPOs (or confirm their registration) in FHA Connection. They also are required to ensure that their TPOs comply with state licensing requirements and that they and their officers, partners, directors, principals, managers, supervisors, loan processors, and loan originators are not ineligible under applicable regulations.

- **Net branching.** States and the FHA generally prohibit net branching (i.e., an arrangement whereby a licensee permits a separate company or branch to engage in activity under the authority of its license) in order to prevent a company or branch that the state has not vetted to effectively “rent a license.” For example, states may conclude a net branching arrangement exists if:
  - The licensee does not pay for the operating expenses or employee compensation for a particular location
  - The branch manager leases the premises
  - The branch manager has control of a corporate checkbook
  - The branch manager has the power to hire or fire personnel
  - All contractual relationships with vendors are in the name of the branch

Social media. More than ever, mortgage industry players are leveraging social media to grow their businesses. Importantly, online and social media content generally must comply with the same laws and regulations as print advertising (e.g., fair lending, TILA, RESPA, consumer privacy, state-specific requirements). For example, advertising on social media must display appropriate license information. Social media sites also should not contain negative or defamatory comments concerning competitors, customers, or third parties. Mortgage brokers should carefully review Federal Financial Institutions Examination Council guidance designed to help financial institutions understand potential consumer compliance, legal, reputational, and operational risks associated with social media.

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The change in leadership and direction at the Consumer Financial Protection Bureau has prompted many providers of consumer financial services to question the importance of a rigorous, well-coordinated compliance management system. Changing emphasis and easing back — and saving some time and expense — is a particularly tempting option at a time when the CFPB leadership has attested that it will no longer “push the envelope” and aggressively assert its supervision and enforcement authority. But covered financial institutions have compelling reasons to maintain a steady focus on CMS, which can:

- Prevent legal violations and consumer harm — both concerns of current CFPB leadership
- Limit scrutiny by states, as enforcement moves in their direction
- Prepare the institution for the inevitable swing of the pendulum back toward enforcement

A strong CMS remains a key component to the long-term success of any company subject to CFPB supervision and enforcement.

The CFPB has said that CMS assessment is one of its most important responsibilities, which is why nearly every CFPB examination or targeted review includes one. So far, the bureau largely has refrained from imposing civil money penalties for general CMS deficiencies uncovered during initial examinations — though it typically requires covered entities to remediate deficiencies quickly. Remediation is a costly endeavor that generally requires cross-departmental enhancement initiatives that can detract from everyday business responsibilities, harming profitability and progress toward strategic objectives.

The CFPB’s public enforcement actions and its regular Supervisory Highlights make clear that companies are still struggling to develop a CMS that fulfills the bureau’s expectations. Shortcomings are occasionally attributable to a failure

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to devote sufficient resources or to provide appropriate oversight of service providers, but given the substantial resources and collaboration required to build and maintain each component of the system, it is not hard to see why maintaining an operationally sustainable CMS that satisfies the CFPB is a challenge.

THE CFPB’S EXPECTATIONS
The CFPB grants companies flexibility in managing and executing a CMS that best suits their size and range of products and services. That said, the CFPB expects two interdependent control components: board and management oversight and a compliance program.iii

BOARD AND MANAGEMENT OVERSIGHT
The board of directors or senior management (typically executives and their designees) must develop and administer a CMS that facilitates compliance with federal consumer financial laws and other relevant federal, state, and agency requirements (taken together, the entity’s legal requirements) and also identifies and minimizes the risk of consumer harm associated with failure to satisfy the legal requirements.iv The CFPB expects senior management to:

- Allocate sufficient resources — including staffing, capital, and technology — to the CMS
- Track changes to legal requirements and enhance the CMS as necessary to address changes
- Identify compliance risks and promptly implement and track appropriate corrective action
- Contemplate regulatory risks associated with new products and services and complete any necessary CMS enhancements prior to offering themv

COMPLIANCE PROGRAM
The compliance program component of a covered entity’s CMS includes the controls that the entity uses to prevent or reduce regulatory violations, and protect consumers from the harm that noncompliance may cause. CFPB’s expectations include:

(a) Written policies and procedures: The CFPB is likely to view an entity’s written policies and procedures as sufficient if the entity designs them to detect and minimize violations and associated risks of consumer harm, and if employees use them as a reference in their day-to-day activities.vi

(b) Training: A compliance training program should (i) be customized for each employee based on responsibilities; (ii) sufficiently address the legal requirements that apply to the entity; and (iii) further reinforce and help implement the standards and principles in the entity’s compliance policies and procedures.vii

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iv Id. at CMR 3-4.
v Id. at CMR 4-5.
vi Id. at CMR 7.
vii Id. at CMR 9.
(c) Monitoring: On an ongoing basis and in a risk-focused manner, companies should monitor and assess their and their service providers’ compliance with legal requirements. The findings should be reported to, among others, senior management.viii

(d) Compliance audit: Audits should (i) inform senior management whether the entity's policies and procedures are being implemented to the board’s standards for compliance and consumer protection, and (ii) address the entity’s level of compliance with legal requirements. Personnel or third parties that conduct the audits should be independent of the compliance function and business units.ix

(e) Consumer complaint management — Companies must maintain a process that ensures that consumer complaints are (i) promptly addressed and resolved and (ii) tracked and analyzed on a continuous basis to identify systemic compliance deficiencies and business practices that lead to consumer harm.x

COMPLIANCE PROGRAM

It is not easy to develop and maintain a CMS that incorporates the controls that the CFPB requires. The following are some strategies that may help:

- *Establish a risk assessment process to determine the scope and frequency of monitoring initiatives and audit activity.* A covered entity should complete a risk assessment at least once a year that includes service providers and prioritizes for frequent and detailed reviews the legal requirements that pose the greater level of potential risk (e.g., regulatory, monetary, operational, and/or reputational). The assessment should yield a residual risk rating for each service provider and legal requirement by comparing the inherent risk to the controls the entity has developed to mitigate these risks and potential consumer harm. Companies should schedule monitoring and audit initiatives based on the residual risk ratings.

- *Develop compliance policies and procedures that provide employees with guidance on satisfying relevant compliance-fulfillment functions.* Policies and procedures that merely regurgitate legal requirements will not lead to a consistent level of compliance. They must also provide specific guidance for business units and support personnel to satisfy compliance-fulfillment functions. If an assigned function requires the use of an automated system or other resource (e.g., loan origination system), the guidance should provide instructions regarding accessing the specific information, documentation, etc.

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The CFPB has said that CMS assessment is one of its most important responsibilities, which is why nearly every CFPB examination or targeted review includes one.
• **Transactional testing.** Covered entities that periodically test their business activity and controls will be in a better position to identify systemic compliance deficiencies and potential consumer harm. A CMS likely will not be effective if the company is not identifying risk in a manner similar to the CFPB’s transaction testing. Testing (as distinct from monitoring) enables the company to assess its level of compliance with legal requirements and the controls developed to facilitate compliance on a transaction-by-transaction basis. While monitoring should be a key aspect of a CMS, it typically involves assessing the fulfillment of a specific compliance function, rather than the broader evaluation of controls that focused testing provides. Thus, periodic testing is an effective means of identifying problematic trends and determining their root cause. Although the CFPB’s recently enhanced Supervision and Examination Manual does not specifically identify compliance testing, the bureau has previously alluded to the need to include compliance testing within the CMS framework.\(^1\)

• **Get more from the audit function.** The audit function should assess the overall effectiveness of the CMS. The CFPB’s independence requirement uniquely positions the audit function to provide an unbiased opinion of the CMS’s effectiveness to senior management. Audit staff should evaluate whether CMS personnel groups are performing their assigned fulfillment functions in a manner consistent with the standards that senior management has established. While some observers regard this process as an inefficient “checking of the checkers,” it is the type of proactive self-assessment that the CFPB is likely to acknowledge during CMS evaluations.

• **Document senior management’s CMS activity.** Senior management is ultimately responsible for implementing and maintaining a successful CMS, and should document its CMS-related actions in meeting minutes, internal memorandums, and bulletins. The CFPB will ask for this type of documentation; companies that produce little or nothing will likely face questions from the bureau about the overall effectiveness of its CMS.

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