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NONTRADITIONAL MORTGAGE PRODUCTS: THE NEW ENFORCEMENT, REGULATORY, AND LITIGATION FRONTIER

Federal Agencies Have Issued a "Guidance" on Nontraditional Mortgage Lending, and Recently Have Complimented it with a "Statement" on Subprime Mortgage Lending. The Authors Describe These Initiatives, Discuss Expected Regulatory and Enforcement Activity, and Suggest Steps Lenders Should Take to Reduce Litigation Risk.
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By Andrew L. Sandler, Benjamin B. Klubes, and Benjamin P. Saul *

I. INTRODUCTION

Every day in the past six months has brought more front-page news reports on the troubles of mortgage lenders – bankruptcy, closing of operations, regulatory examinations, Securities and Exchange Commission and Justice Department investigations, class action lawsuits, Congressional hearings and draft legislation, restatement of earnings, and tightening of credit standards by originators and secondary market purchasers. Such well-reported industry troubles have caused precipitous drops in the stock prices of many non-prime and prime lenders. Shock waves from these declines have rippled through the broader stock and bond markets, contributing to declines in markets worldwide, significant losses for hedge funds, coordinated national bank interventions, and a severe "credit crunch."

At the center of this storm are nontraditional and adjustable-rate mortgage products. Over the past several years, these products have greatly expanded the availability of mortgages, principally by making the initial monthly payments more affordable to borrowers. Delinquencies and foreclosures associated with the products, however, have significantly increased. Most commentators and industry experts predict further

* *ANDREW L. SANDLER and BENJAMIN B. KLUBES are partners, and BENJAMIN P. SAUL is an associate, in the Washington, D.C. office of Skadden, Arps, Slate, Meagher & Flom, LLP. Mr. Sandler leads the firm's Consumer Financial Services Enforcement and Litigation practice. The authors represent financial services companies in connection with government civil and criminal enforcement proceedings, regulatory examinations and investigations, and class action litigation. Their e-mails are, respectively, asandler@skadden.com, bklubes@skadden.com and bsaul@skadden.com.*

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dramatic increases in delinquency and foreclosure rates. Numerous members of Congress have proposed legislation to address these issues.[1] State lawmakers have been at least as aggressive and have introduced over 80 mortgage reform bills to address such issues.[2] Federal and state banking regulators, in part due to pressure from Congress, have principally reacted to nontraditional mortgage products and related developments with new regulatory guidance. Federal and state law enforcement, as well as class action lawyers, are squarely focused on the non-prime lending industry.

Mortgage products that permit borrowers to trade lower payments during an introductory period for potentially significantly higher payments during a later period, referred to variously as "nontraditional," "alternative," or "exotic" mortgage loans (hereinafter "nontraditional" mortgage loans), include both "interest-only" mortgage loans, where a borrower defers payment of loan principal for a specified period, and “payment-option” adjustable-rate mortgages, where a borrower has several payment options, including sometimes negative amortization, wherein the borrower pays less than full interest accruing for an initial loan period. Although these products have contributed to the highest levels of home ownership in American history, the press, lawmakers, regulators, and community groups are concerned that the already sizable number of borrowers who have defaulted on their loans due to an inability to meet increasing mortgage payments or refinance will further multiply.

This increased focus on the perceived threat nontraditional mortgage loans pose to consumers has caused the federal banking regulators – the Office of Thrift Supervision (“OTS”),[3] the Office of the Comptroller of the Currency (“OCC”), the Federal Reserve Board of Governors (“the Fed”), the Federal Deposit Insurance Corporation (“FDIC”), and the National Credit Union Administration (collectively, the “Agencies”) – to issue *Interagency Guidance on Nontraditional Mortgage Products* (the "*Guidance*").[4] The *Guidance* applies to all negative amortization and interest-only mortgages, but not to reverse mortgages, fully amortizing residential mortgage loan products or home equity lines of credit ("HELOC" products).[5] In addition, the Agencies – at the urging of consumer groups and some members of Congress[6] – issued a *Statement on Subprime Mortgage Lending* (the “*Statement*”)[7] that addresses certain risks and issues relating to subprime mortgage lending practices, including adjustable-rate mortgages (“ARMs”). The

[1] *See, e.g.*, Cooper, Christopher, *Democrats Raise Heat On Mortgage Overhaul*, WALL ST. J., Aug. 7, 2007 (discussing Sen. Clinton’s mortgage plan); *see also* Seiberg, Jaret, *Clinton Mortgage Plan: Roadmap for Democratic Response*, STANFORD GROUP – WASH. FIN. SERV. BULL., Aug. 8, 2007 (discussing the mortgage plans of Sens. Clinton and Schumer). In addition to Sen. Schumer’s bill and Sen. Clinton’s plan, Rep. Frank, Sen. Dodd, and Rep. Bachus both have introduced mortgage reform bills.

[2] *See, e.g.*, Veshkin, Alison, *States Push Ahead With Subprime-Mortgage Laws as Congress Lags*, BLOOMBERG NEWS, Jun. 10, 2007 (summarizing burgeoning state initiatives). *See also* N.C. Sess. Laws 2007-352 (including, among other provisions, a requirement that lenders must first consider a borrower's ability to repay before approving a rate spread home loan).

[3] In August 2007, the OTS, independently, issued advance notice of proposed rulemaking by which it seeks to render certain mortgage lending practices “unfair and deceptive.” 12 C.F.R. Part 535.

[4] 71 Fed. Reg. 58,609 (Oct. 4, 2006).

[5] With respect to HELOC products that contain interest-only features, the Agencies instead elected to issue a September 2006 Addendum to their May 2005 *Interagency Credit Risk Management Guidance for Home Equity Lending* (the "*HELOC Addendum*"). The *HELOC Addendum* urges lenders to ensure that advertisements, oral statements, promotional materials, and periodic statements provide clear and balanced information to consumers early in the loan shopping process about the benefits and risks of interest-only HELOC products, including information on the risk that future payments will increase, the circumstances that may trigger an increase, and whether a prepayment penalty exists.

[6] *See, e.g.*, *Subprime ARMs, NTMs in Government Spotlight*, HOME EQUITY WIRE, Feb. 1, 2007 ("Sen. Dodd . . . recently urged the regulators to expand the nontraditional mortgage guidance to include 2/28 ARMS . . . .").

[7] 72 Fed. Reg. 37,569 (Jul. 10, 2007).

Statement complements the *Guidance*, which does not specifically address amortizing ARM products. The Conference of State Bank Supervisors ("CSBS") and the American Association of Residential Mortgage Regulators ("AARMR"), in an effort to provide analogous model state guidance, followed the Agencies' suit by issuing both *Guidance on Nontraditional Mortgage Risk* (the "*State Guidance*") and *Statement on Subprime Mortgage Lending* (the "*State Statement*").[8]

This article describes current concerns surrounding nontraditional mortgage loans (Section II), details the substance of the *Guidance* and *Statement* (Section III), discusses expected regulatory and enforcement activity (Section IV), and sets forth compliance initiatives financial services companies can use to reduce their enforcement and litigation risk (Section V).

II. CONCERNS REGARDING NONTRADITIONAL MORTGAGE PRODUCTS

According to a 2006 report that the Government Accountability Office provided to Congress, nontraditional mortgage lending tripled from 2003 through 2005,[9] and the rapid growth continued in 2006.[10] This rapid expansion has engendered two principal concerns among state and federal regulators, economists, and consumer advocates: first, that many borrowers who obtain nontraditional mortgage products do not understand their terms and conditions and will suffer "payment shock" and could default when their loans begin to amortize; and second, that a string of such defaults will threaten the solvency of lender financial institutions. This article focuses on the approach of regulators with respect to the first of these concerns – the negative implications for consumers.

In late September 2006, senior officials from the OCC, the Fed, the FDIC, and the OTS all testified before the Senate Committee on Banking, Housing, and Urban Affairs. The common theme of their testimony is that the sale of nontraditional mortgage products to less sophisticated borrowers without adequate financial resources can lead to negative financial consequences for lenders and borrowers. For example, the testimony of Deputy Comptroller Kathryn E. Dick summarized the OCC's concerns by stating:

> [T]he risks associated with nontraditional mortgage products . . . now apply to a wider spectrum of borrowers, including some who may not fully understand the financial risks they are assuming . . . . [T]hese [nontraditional mortgage] products may expose both the borrower and a financial institution to unwarranted levels of risk in a stressed environment [in which interest rates rise or home prices fall] . . . [Further,] nontraditional mortgage products are relatively complex, and borrowers unfamiliar with them – which means most borrowers – would benefit greatly from improvements in both the content and timing of disclosures.[11]

Economists, including former Fed Chairman Alan Greenspan and former Fed Governor Susan Schmidt Bies, have long maintained that nontraditional mortgage loans distorted the cost of capital and contributed to the now deflated house-price bubble, as well as to unsustainable levels of consumer debt.[12] Consumer groups and the news media, moreover, have oft-warned that rising rates and a soft housing market have left borrowers in nontraditional mortgage loans unprepared for and unable to make significantly higher monthly

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[8] Conference of State Bank Supervisors & American Association of Residential Mortgage Regulators, *Guidance on Nontraditional Mortgage Risks* (Nov. 14, 2006) *available at* http://www.csbs.org; Conference of State Bank Supervisors & American Association of Residential Mortgage Regulators, *Statement on Subprime Mortgage Lending* (Jul. 17, 2007) *available at* http://www.csbs.org.

[9] *Calculated Risk: Assessing Nontraditional Mortgage Products: Hearing Before S. Comm. on Banking, Housing and Urban Affairs, Subcomm. on Housing and Transportation and Economic Policy*, 109th Cong. (2006) (written testimony submitted by Orice M. Williams, Director Financial Markets and Community Investments, United States Government Accountability Office).

[10] Kristin Downey, *Nontraditional Mortgages Don't Wane Under Warning*, WASH. POST, Oct. 24, 2006, at D1 (noting that interest-only and payment-option ARMs as a percentage of all originations grew roughly six percent during the first half of 2006 relative to 2005).

[11] *Calculated Risk: Assessing Nontraditional Mortgage Products: Hearing Before S. Comm. on Banking, Housing and Urban Affairs, Subcomm. on Housing and Transportation and Economic Policy*, 109th Cong. (2006) (testimony of Kathryn E. Dick, Deputy Comptroller of the Currency).

[12] *See, e.g.*, *The Economic Outlook, Before the Joint Economic Comm.*, 109th Cong. (2005) (statement of Alan Greenspan, Federal Reserve Board Chairman); Susan Schmidt Bies, Governor, Federal Reserve Board, Remarks at the America's Community Bankers Risk Management and Finance Forum (Apr. 10, 2006).

payments, unable to refinance their loans, and at risk of foreclosure.[13] Consumer groups, further, have maintained that lenders have more aggressively marketed nontraditional mortgage products – especially payment-option and interest-only loans – to minority borrowers with weak credit scores.[14]

News reports linking nontraditional mortgage products to rising default and foreclosure rates appear almost daily.[15] Investment advisors have issued reports concluding that nontraditional mortgage products are a major factor in the spike in foreclosure activity – particularly in western housing markets.[16]

Over $1.2 trillion in adjustable-rate loans have or will reset in 2007, with much of this amount resetting in the fourth quarter.[17] Given such data, the stressed markets and an already heightened regulatory and legislative focus, further increases in defaults traced to the growth of nontraditional mortgage loans only will hasten enforcement activity directed at lenders selling nontraditional loan products to economically vulnerable consumers. Such lenders, therefore, are well advised to study carefully the *Guidance*, the *Statement* and, as applicable, the *State Guidance* and *State Statement*, and to adapt their lending practices accordingly.

III. THE GUIDANCE AND STATEMENT – AN OVERVIEW

The Guidance

The *Guidance* highlights the Agencies' view that the risks associated with nontraditional mortgage products are particularly acute for non-prime and other borrowers with lower credit scores. These borrowers represent a growing source of revenue for lenders offering nontraditional mortgage products and the Agencies view them as less able to understand the dangers associated with these products. The *Guidance* stresses that institutions should review and, as appropriate, revise their nontraditional mortgage product policies in three areas: maintaining a safe and sound underwriting process, maintaining suitable portfolio and risk management practices, and ensuring business practices adequately protect consumers. This article focuses on the underwriting and consumer protection aspects of the *Guidance*.[18]

Loan Terms and Underwriting Standards

When discussing loan terms and underwriting practices, the *Guidance* places primary emphasis on borrower qualification standards and repayment analysis,

[13] *See, e.g.*, *Calculated Risk: Assessing Nontraditional Mortgage Products: Hearing Before S. Comm. on Banking, Housing and Urban Affairs, Subcomm. on Housing and Transportation and Economic Policy*, 109th Cong. (2006) (testimony of Allen J. Fishbein, Director of Housing and Credit Policy, Consumer Federation of America).

[14] Bocian, Debbie Gruenstain, Ernst, Keith S. and Li, Wei, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgage*, Center For Responsible Lending (May 31, 2006).

[15] *See, e.g.*, Ivry, Bob, *Bernanke Was Wrong: Subprime Contagion Is* Spreading, BLOOMBERG NEWS, Aug. 10, 2007 (noting that Chairman Bernanke testified to Congress that "rising delinquencies and foreclosures are creating personal, economic, and social distress for many homeowners and communities – problems that will likely get worse before they get better"); Simon, Ruth & Haggerty, James R., *Mortgage Defaults Start to Spread: New Data Show that Nontraditional Loans Are Beginning to Haunt Borrowers With Midlevel Credit; Prime Still Fine*, WALL ST. J., Mar. 1, 2007 (noting the "credit deterioration [among Alt-A mortgages] has been almost parallel to . . . the subprime market"); Whitehouse, Mark, *Risk Management: As Home Owners Face Strains, Market Bets on Loan Defaults*, WALL ST. J., Oct. 30, 2006 (noting that, in addition to the risk of a bearish housing market, subprime borrowers will face payment shock when loans reset, a trend that some experts predict "will lead to some 450,000 added [subprime] defaults" over the next five years, while others estimate "that by 2008 as many as one in five of all subprime borrowers will be in arrears . . . .").

[16] *See* Ivry, *supra* note 15; Simon, Ruth & Haggerty, *supra* note 15; Whitehouse, *supra* note 15. *See also Foreclosures.com: Exotic Mortgages Sinking Western Homeowners*, BUS. WIRE, Sept. 25, 2006.

[17] Cutts, Amy Crew, *Facts and Figures on New Mortgage Products*, Federal Trade Commission Workshop, *Protecting Consumers in the New Mortgage Marketplace*, Slide 7 (May 24, 2006) *available at http://www.ftc.gov/bcp/workshops/mortgage/presentations/cutts.pdf* (citing data compiled by Freddie Mac, JP Morgan Chase Bank, Citigroup and Credit Suisse First Boston).

[18] We note, however, that the *Guidance*'s discussion of portfolio and risk management practices highlights the Agencies' concern that nontraditional mortgage loans, especially those paired with risk-layering features, have not been tested in "a stressed environment." 71 Fed. Reg. at 58,615. Accordingly, the *Guidance* provides, generally, that such loans require "higher levels of monitoring and loss mitigation" and directs financial institutions to regularly monitor and assess the risk profiles associated with them. *Id*. at 58,616.

the potential for collateral dependent loans, and risk layering. A key undercurrent of the *Guidance*'s discussion of underwriting practices is that the Agencies want institutions to mitigate the risk of default due to the "payment shock" potentially tied to an increase in monthly mortgage payments when a nontraditional loan begins to fully amortize. The *Guidance* further cautions financial institutions both "against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies,"[19] and not to succumb to "competitive pressures"[20] that might interfere with their responsibility to maintain safe and sound underwriting practices.

The *Guidance* states clearly that institutions must consider a borrower's ability to repay a loan by final maturity at the fully indexed rate when the loan is fully amortized. The *Guidance* does not require institutions to assume worst-case interest rates.

In its discussion of collateral dependent loans, ***i.e.,*** loans to borrowers who do not demonstrate the capacity to repay from sources other than the pledged collateral, the *Guidance* cautions that such loans are "generally considered unsafe and unsound."[21] The *Guidance* states that institutions should "avoid the use of loan terms and underwriting practices that may result in the borrower having to rely on the sale or refinancing of the property once amortization begins."[22] Lenders that originate collateral-dependent mortgage loans will be subject to "criticism, corrective action, and higher capital requirements."[23]

The *Guidance* permits risk-layering practices, but notes that when lenders increase the risk inherent in nontraditional mortgage products, they need to demonstrate heightened scrutiny of such practices, as well as offsetting factors. The *Guidance* further identifies the following practices that, when combined with nontraditional mortgage terms, could add up to unacceptable risk layering. These include: reduced-documentation loans, simultaneous second-lien mortgages, introductory interest rates, and targeting non-prime borrowers. With respect to reduced-documentation loans, the *Guidance* indicates that lenders should avoid "over-reliance on credit scores as a substitute for income verification in the underwriting process."[24] As for simultaneous second-lien loans, the *Guidance* notes that such loans "with minimal or no owner equity **. . .** should generally not have a payment structure that allows for delayed or negative amortization."[25] When discussing introductory interest rates, the *Guidance* cautions lenders to endeavor to minimize "the spread between the introductory rate and the fully indexed rate."[26] The *Guidance* stresses that lenders developing nontraditional mortgage loans for non-prime borrowers should ensure they both adhere to the *Guidance* as well as Subprime Lending guidance that the Agencies issued in March 1999 and later expanded in January 2001.[27]

Consumer Protection Concerns

The *Guidance* attempts to address the concern that consumers do not fully understand the terms and conditions of nontraditional mortgage products. It sets forth recommended practices meant to ensure that borrowers have sufficient information to clearly understand loan terms and associated risks. Specifically, the *Guidance* directs lenders to:

- provide consumers with clear and balanced promotional information that highlights both the relative benefits and the risks of nontraditional mortgage products at a time that will help them decide whether to select such products;

- disclose to consumers – using realistic hypotheticals – that monthly payment amounts could increase in the future, explaining how new payment amounts will be calculated;

- disclose in product descriptions, when applicable, the possibility of negative amortization and the potential consequences of increasing principal balances and decreasing home equity;

- ensure that monthly payment statements related to payment-option loans provide information that enables consumers to make responsible payment choices, including information about the

[19] 71 Fed. Reg. at 58,613.

[20] *Id.*

[21] *Id.* at 58,614.

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Interagency Guidance on Subprime Lending*, Mar. 1, 1999, and *Expanded Guidance for Subprime Lending Programs*, Jan. 31, 2001. The *Guidance* further directs federally insured credit unions to refer to *04-CU-12-Specialized Lending Activities* (NCUA).

consequences of selecting different payment options on the current principal balance;

- avoid practices that obscure significant risks to the consumer; and
- adopt compliance control systems to ensure actual practices remain consistent with policies and procedures.

Simultaneously with the *Guidance*, the Agencies released proposed illustrations of the consumer disclosures it described.[28] The illustrations were finalized on June 8, 2007.[29]

The Statement

The *Statement*, which reiterates many principles addressed in existing guidance, applies to federally regulated lenders. Its original release followed Freddie Mac's publication of stricter guidelines for subprime hybrid ARM products.[30] The *Statement* reflects the Agencies' concern that subprime borrowers may not fully appreciate the risks and consequences of obtaining ARM products, and discusses underwriting criteria and factors – including payment shock – that lenders should consider in making such loans.[31] The *Statement* indicates that the Agencies are most concerned with the following ARM features:

- introductory "teaser" rates;
- low- or no-documentation loans;
- high or no limits on payment or rate caps; and
- substantial prepayment penalties or prepayment penalty periods that exceed the initial interest-rate adjustment period.[32]

The underwriting standards set forth in the *Statement* draw heavily on those in the *Guidance*. In particular, the *Statement* directs lenders to approve ARMs based on a borrower's ability to repay the fully indexed rates – rather than based on "teaser" rates.[33] The *Statement*, like the *Guidance*, discourages "risk-layering practices," such as lower credit scores coupled with high loan-to-value ("LTV") ratios.[34]

Like the *Nontraditional Guidance*, the *Statement* recommends practices meant to ensure that borrowers have sufficient information to clearly understand loan terms, costs, and associated risks at a time when the information can help borrowers select loan products. Specifically, the *Statement* indicates that consumers should be informed of:

- the risk of payment shock;
- the existence and duration of a prepayment penalty and how that penalty will be calculated;
- the existence of any balloon payments;
- any pricing premiums associated with no- or reduced-documentation loans; and
- the requirement to make real estate tax and insurance payments, if not escrowed.[35]

The *Statement* also includes provisions on workout arrangements to encourage lenders to work constructively with residential borrowers in default or whose default is reasonably foreseeable.[36] On August 14, 2007, the Agencies issued proposed illustrations of consumer information for certain ARM products described in the *Statement*.[37] Comments on the proposed illustrations are due within 60 days of publication in the Federal Register.

Regulation of Non-bank Lenders

Although the *Guidance* and the *Statement* do not apply to lenders and mortgage brokers that are not federally regulated, federal regulators have urged states to ensure that the lenders they oversee adhere to the same nontraditional mortgage guidelines being applied to insured banks and thrifts. In a mid-October 2006 speech, Comptroller John C. Dugan noted "[i]t is

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[28] 71 Fed. Reg. 58,672 (Oct. 4, 2006).

[29] 72 Fed. Reg. 31,825 (Jun. 8, 2007).

[30] Press Release, Freddie Mac, *Freddie Mac Announces Tougher Subprime Lending Standards to Help Reduce the Risk of Future Borrower Default* (Feb. 27, 2007) *available at http://www.freddiemac.com/news/archives/corporate/2007/20070227_subprimelending.html*.

[31] 72 Fed. Reg. at 37,572.

[32] *Id.*

[33] *Id.* at 37,573-4.

[34] *Id.*

[35] *Id.* at 37,573.

[36] *Id.* at 37,574.

[37] 72 Fed. Reg. 45,495 (Aug. 14, 2007).

essential for state regulators to embrace [efforts to police nontraditional mortgages]" and "to deploy the necessary resources to effectively enforce these standards" against originators not subject to the *Guidance*.[38] State regulators have promised to adopt parallel guidance and issue similar rules for the lenders and mortgage brokers they regulate. And, on November 14, 2006, CSBS and AARMR released their *State Guidance*, which mirrors the *Guidance* as it relates to consumer protection and underwriting issues.[39] In July 2007, CSBS and AARMR released a statement that parallels the *Statement* for state regulators to use in oversight of subprime ARM lending.[40] The Federal Trade Commission, which also has jurisdiction over certain non-bank lenders, continues to explore whether it will take action.

IV. PROBABLE REGULATORY, LAW ENFORCEMENT, AND CLASS ACTION ACTIVITY

Mortgage lenders should expect further scrutiny from federal and state regulators with respect to their underwriting and marketing of nontraditional mortgage loans. Inevitably, such examinations and related investigations will result in additional federal and state enforcement activity. Federal banking regulators, for example, have already and will continue to police unsound underwriting practices, as well as unfair or deceptive marketing of nontraditional mortgage products.[41] To a lesser degree, regulators also will seek to enforce Truth in Lending Act's ("TILA's") disclosure requirements against lenders improperly marketing and underwriting nontraditional mortgage loans.

With respect to federal law enforcement, lenders should anticipate that the FTC will utilize Section 5 of the Federal Trade Commission Act[42] to initiate enforcement activity with respect to unfair and deceptive marketing of nontraditional mortgage products. Lenders also should expect that the Civil Rights Division of the Department of Justice, which has responsibility for enforcing fair lending claims under the Equal Credit Opportunity Act[43] and the Fair Housing Act,[44] will investigate and bring enforcement actions against lenders it suspects have targeted higher-cost and higher-risk nontraditional mortgage loans to borrowers in a protected class.[45] Lenders who have high concentrations of loan originations and foreclosures in minority areas likely will receive the greatest scrutiny from the DOJ.

As states adopt the *State Guidance* and *State Statement*,[46] state regulators will conduct detailed examinations of lenders' nontraditional mortgage product marketing and underwriting policies and procedures. Given the already heightened federal scrutiny, state scrutiny will further catalyze related state regulatory and attorneys general investigations. In particular, lenders should expect state attorneys general to initiate enforcement actions pursuant to state consumer protection and anti-predatory lending statutes against lenders whose business practices fall short of those outlined in the federal and state regulatory initiatives. State attorneys general, who typically are responsible for enforcing state anti-discrimination laws analogous to the Equal Credit Opportunity Act ("ECOA") and the Federal Housing Administration ("FHA"), also are likely to investigate and initiate enforcement activity against lenders suspected of unfairly targeting nontraditional mortgage loans to minority borrowers.

[38] John C. Dugan, Comptroller of the Currency, Remarks at the America's Community Bankers Convention (Oct. 16, 2006).

[39] *See supra* note 8. At the time of publication, most states had implemented the *State Guidance* in its entirety, with others poised to do so.

[40] *See supra* note 8.

[41] *See, e.g.,* OTS Supervisory Agreement, 07-041 (Jun. 7, 2007) (finding bank failed to "manage and control" loan origination services it outsourced in a "safe and sound" manner, resulting in inadequate consideration of borrower creditworthiness and in large broker and lender fees); *In re Fremont Inv. & Loan*, No. FDIC-07-0356 (Mar. 7, 2007) (Consent Agreement) (finding company marketed ARMs to subprime borrowers in an "unsafe and unsound" manner and "without considering a borrower's ability to repay").

[42] 15 U.S.C. §§ 41-58.

[43] 15 U.S.C. §§ 1691-1691f.

[44] 42 U.S.C. §§ 3601-3631.

[45] *See, e.g.*, *Hargraves v. Capital City Mortgage Corp.*, 140 F. Supp. 2d 7 (D.D.C. 2000) (establishing a two-pronged test for reverse redlining that requires proof that the defendant's lending practices and loan terms were predatory and unfair, and that the defendant intentionally targeted borrowers because of their race or that the defendant's lending practices had a disparate impact on the basis of race). The FTC, under certain circumstances, shares responsibility for enforcement of fair lending laws, including ECOA. *See, e.g.*, *F.T.C. v. Capital City Mortgage Corp.*, 321 F. Supp. 2d 16 (D.D.C. 2004).

[46] Lenders should continue to monitor whether and, if so how, states adopt the *State Guidance*. Although those states that have adopted the *State Guidance* have done so entirely, some of the remaining states might elect to convert the *State Guidance* into statutory law enforceable by state attorneys general, private parties, or both.

In addition to federal and state regulatory and enforcement activities, lenders should expect plaintiffs' lawyers to utilize the *Guidance* and the *Statement* as blueprints for fair and predatory lending lawsuits, including class actions, against lenders making nontraditional mortgage loans. These private individual and class actions likely will allege that lenders inadequately disclosed the nature and risks associated with nontraditional mortgages, and failed to determine whether the nontraditional mortgages were suitable for targeted borrowers.[47] Private plaintiffs have already and likely will continue to advance fair lending class actions in which they allege reverse redlining in the marketing and pricing of nontraditional mortgage loans – particularly to non-prime borrowers.[48]

V. COMPLIANCE STRATEGIES TO REDUCE ENFORCEMENT AND LITIGATION RISKS

Given the increased regulatory scrutiny of nontraditional mortgage products, the likelihood of further federal and state enforcement in this area, and the high risk of private litigation concerning nontraditional mortgage products, lenders should review and, when appropriate, revise policies and procedures to bring them in line with the *Guidance* and the *Statement.* We recommend that lenders consider certain "best practices" when developing and marketing nontraditional mortgage products.

A. Develop Products with Clearly Defined Terms for Appropriate Markets.

When designing new nontraditional mortgage products, lenders should carefully define both the product terms and conditions, and the target borrower. To mitigate credit risks associated with new nontraditional mortgage products, lenders should ensure that they update and implement relevant underwriting controls.

B. Provide Prospective Borrowers with Timely, Straightforward, and Objective Marketing Materials and Product Disclosures.

Lenders should ensure they provide borrowers with information about available nontraditional mortgage products that empowers the consumer to make informed decisions when selecting a mortgage product. When drafting product disclosures, lenders should utilize the Agencies' disclosure illustrations as a general guideline.

More specifically, lenders should use product disclosures as a means to minimize borrowers' payment shock. Nontraditional mortgage product disclosures, therefore, should inform consumers of the amount by which their future payments could increase, ensuring such calculations reflect the applicable contractual limits on interest rates and negative amortization. Similarly, disclosures also should explain when and how loans will reset, as well as the reset payment amount. When loan terms permit negative amortization, lenders should detail for borrowers the potential adverse consequences of negative amortization, such as increased principal balances and decreased home equity. With respect to no- or reduced-documentation loans, lenders should disclose, up front, any pricing premiums associated with them. When nontraditional mortgage products contain prepayment penalties, lenders should disclose the potential fee.

Lenders should ensure that they provide all product disclosures as soon as possible to the consumers (preferably before an application is submitted) in order to help them to select a mortgage product. Further, lenders should prepare product disclosures using plain language. Lenders should consider requiring mortgage bankers and sales staff to relay verbally key elements of product disclosures to customers.

C. Avoid Practices that Obscure Risks.

Lenders should take care to avoid practices that obscure significant risks to the consumer. For example, lenders should not promote "payment patterns that are structurally unlikely to occur."[49] Further, lenders should avoid other practices, such as: offering unwarranted assurances or predictions about the future direction of interest rates or promoting the cash savings or expanded buying power of nontraditional mortgage products in a one-sided manner.

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[47] *See, e.g.*, *Andrews v. Chevy Chase Bank*, Case No. 05C0454 (E.D. Wisc. 2007) *appeal filed,* No. 07-1326 (7th Cir. 2007) (certifying a class and granting summary judgment to plaintiffs on their claims that Payment-Option ARM disclosures were inadequate under TILA).

[48] *See, e.g.*, *NAACP v. Ameriquest Mortgage Co. et al.*, Case No. 8:2007cv00794 (C.D. Cal. Jul. 2007) (alleging fair lending claims, including reverse redlining of subprime mortgage loans, and seeking declaratory and injunctive relief); *see also Miller v. Countrywide Bank* (D. Mass. Jul. 2007) (pleading counts that parallel allegations in the *NAACP* matter, but seeking damages); *Jeffries v. Wells Fargo Nat'l Bank*, Case No. C-07-3880 (N.D. Cal. Aug. 2007) (paralleling allegations in the *Countrywide* matter).

[49] 71 Fed. Reg. at 58,618.

D. Ensure Billing Statements Provide Borrowers with Information Sufficient to Make Responsible Payment Choices.

Lenders should ensure that all monthly billing statements detail a borrower's outstanding loan balance, how much of a borrower's previous payment was allocated to principal and how much to interest and, when applicable, whether and by how much a borrower's principal balance increased. Lenders who offer payment-option ARMs should ensure that monthly billing statements for such products contain enough information for borrowers to understand the consequences of each of their payment options. Specifically, statements should detail each payment option and highlight that the applicable minimum payment amount option will increase the consumer’s outstanding loan balance due to negative amortization.

E. Implement Training Programs and Compliance Controls.

Lenders should ensure that their employees receive training that explains the *Guidance* and the *Statement*, as well as any changes in sales and underwriting policies or practices made pursuant to the *Guidance* or *Statement*. Further, lenders should implement the legal and compliance controls necessary to ensure their employees adhere to any new policies and procedures. For those lenders utilizing mortgage brokers, consideration should be given to the controls that ensure brokers adhere to the *Guidance* and the *Statement* by, for example, providing product disclosures and not improperly steering applicants to nontraditional mortgage products.

VI. CONCLUSION

In sum, the best proactive risk mitigation calls for lenders to ensure that they put in place rigorous underwriting and compliance controls, and provide borrowers with timely, clear, and concise product disclosures.■