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By Phillip L. Schulman and Emily J. Booth

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The Subprime Situation

A number of the articles here explore a variety of important issues relating to the subprime market meltdown, beginning with our lead piece, “Filling The Subprime Void—The FHA Revival,” by Phillip L. Schulman and Emily J. Booth of the Washington, DC, office of K&L Gates.

As Mr. Schulman and Ms. Booth observe, in the wake of the downturn of the subprime market, residential mortgage lenders are showing a new or renewed interest in the mortgage insurance programs of the Federal Housing Administration, which Congress enacted over 70 years ago to meet the needs of underserved borrowers with impaired credit. Lenders view recent changes that the US Department of Housing and Urban Development has made to FHA lending guidelines, including changes to appraisal protocols, closing costs, property inspection guidelines and refinance guidelines, as empowering and revitalizing the FHA, which had lost market share to private mortgage insurance programs in recent years. The authors emphasize, however, that it is important to remember that the FHA program is rules based, about as rules based as one will find in the residential mortgage lending industry. Failure to follow these rules may lead not only to loss of governmental approval, but also to demands for indemnification and civil money penalties. Couple this dynamic with the fact that FHA rules and regulations are difficult to decipher, and one rapidly will conclude that jumping into FHA lending requires substantial advance planning.

This article summarizes the history and purpose of the FHA, outlines the FHA’s operational requirements and enforcement initiatives, describes the complex web of authorities that one must consult to navigate the FHA system, and discusses the industry’s renewed interest in FHA programs.

LENDING GUIDANCE

Earlier this year, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision and National Credit Union Administration issued the Proposed Statement on Subprime Mortgage Lending for notice and comment. In response to the issuance of the proposed statement, the agencies received 137 comment letters. After reviewing these comments, the agencies issued the final Statement on Subprime Mortgage Lending on June 27. The final statement was effective July 10, 2007.

The Latest Attempt To Regulate Subprime Mortgage Lending: The Federal Banking Agencies Issue The Subprime Mortgage Lending Guidance

By Jeffrey Taft

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Earlier this year, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision and National Credit Union Administration (collectively, the Agencies) issued the Proposed Statement on Subprime Mortgage Lending (Proposed Statement) for notice and comment.¹ In response to the issuance of the Proposed Statement, the Agencies received 137 comment letters. After reviewing these comments, the Agencies issued the final Statement on Subprime Mortgage Lending (Statement) on June 27.² The Statement was effective July 10, 2007.

The Agencies developed the Statement to address concerns about certain underwriting practices and borrower misunderstanding about the risks and consequences of obtaining adjustable rate mortgage products that can cause payment shock when their payments reset. The Statement is one of the recent attempts by the Agencies and Congress to address concerns about origination and underwriting practices in the subprime mortgage lending market.

COVERAGE OF THE STATEMENT

Entities Covered

The Statement applies to all banks and their subsidiaries, bank holding companies and their

nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions (collectively, financial institutions). While the Statement does not cover state licensed non-bank lenders, the Conference of State Bank Supervisors (CSBS), the American Association of Residential Mortgage Regulators, and the National Association of Consumer Credit Administrators have indicated that many states plan to adopt similar guidance for their licensed mortgage lenders.³

Activities Covered

The Statement is primarily focused on the subprime mortgage origination activities of financial institutions. While it is silent regarding the purchase of subprime residential mortgage loans, financial institutions should limit their purchase of mortgage loans to those that comply with the Statement. Furthermore, financial institutions may want to monitor their purchase of mortgage backed securities representing an interest in pools of loans that do not comply with the requirements set forth in the Statement.

Definition of Subprime

Many commenters requested that the Statement include a definition of "subprime." After considering this point, the Agencies decided not to create a definition of subprime for purposes

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of the Statement. Instead, the Agencies determined that the reference to the subprime borrower characteristics from the Agencies' Expanded Guidance for Subprime Lending Programs (Expanded Guidance)⁴ provided appropriate information for purposes of the Statement. The Expanded Guidance provides a range of credit risk characteristics that are associated with subprime borrowers, noting that these characteristics are illustrative and are not meant to define specific parameters for all subprime borrowers.

Coverage of Prime Loans

The Agencies specifically requested comment about whether the principles of the Proposed Statement should apply beyond subprime adjustable rate mortgage (ARM) loans. While the Agencies ultimately declined to expand the focus of the Statement beyond subprime mortgage loans, they noted that financial institutions generally should look to the principles of the Statement when ARM loans are offered to prime borrowers.

RISK MANAGEMENT PRACTICES

Predatory Lending Considerations

At its outset, the Statement expressly provides that subprime lending is not synonymous with predatory lending, and that there is no presumption that the subprime loans covered by the Statement are predatory. Financial institutions are directed to ensure that they do not engage in the types of predatory lending practices discussed in the Expanded Guidance. Typically, predatory lending involves at least one of the following elements: (i) loan flipping; (ii) making loans based upon the value of the underlying property rather than the borrowers' ability to repay; or (iii) fraudulent or deceptive practices.

Underwriting Standards

The Proposed Statement required financial institutions to underwrite subprime hybrid ARM loans⁵ at the fully indexed rate with a fully amortizing repayment schedule. Over the past few years, lenders had generally underwritten these loans based upon the borrowers' ability to make the initial monthly payments which were lower due to the reduced initial rate. Some commenters suggested that lenders should underwrite the borrower based upon a blended interest rate which considers both the initial and subsequent rates. Other commenters suggested that these loans should

be underwritten on the basis of the maximum possible monthly payment, but the Agencies did not believe that was necessary. The Proposed Statement's general requirement of qualifying borrowers at the fully indexed rate, assuming a fully amortizing payment, remains unchanged in the Statement. The Agencies have, however, provided additional information regarding the terms "fully indexed rate" and "fully amortizing payment schedule" to clarify expectations regarding how financial institutions should assess a borrower's repayment capacity.⁶

The Agencies also stressed the importance of prudent qualifying standards that recognize the potential effect of payment shock in evaluating a borrower's ability to repay the loan. A financial institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The Agencies encouraged financial institutions to qualify a borrower's repayment capacity by reviewing the debt-to-income (DTI) ratio. An institution's DTI analysis should include, among other things, an assessment of a borrower's total monthly housing-related payments *e.g.*, principal, interest, taxes, and insurance, (PITI) as a percentage of gross monthly income.

An accurate assessment of a borrower's repayment ability is particularly important if the financial institution relies upon reduced documentation or allows other forms of risk-layering. A common example of risk-layering would involve a mortgage loan with a high LTV ratio, no income verification, and a low fixed interest rate for the first two years. Although each of these factors may not individually present a higher risk of default, when combined they present significant risk for financial institutions and borrowers.

Financial institutions are expected to have clear policies governing the use of risk-layering features, such as reduced documentation loans or simultaneous second lien mortgages. When risk-layering features are combined, an institution should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.

Reduced Documentation and Stated Income Loans

Like the Proposed Statement, the Statement does not expressly prohibit reduced documentation or stated income loans. The Statement provides that stated income and reduced documentation loans are acceptable if there

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are mitigating factors that clearly minimize the need for verification of repayment capacity. According to the Statement, mitigating factors exist when a borrower with favorable payment performance seeks to refinance an existing mortgage with a new loan of a similar size and with similar terms, and the borrower's financial condition has not deteriorated. Other mitigating factors might include situations where a borrower has substantial liquid assets that demonstrate repayment capacity and the existence of such assets can be verified and documented by the institution. Financial institutions are expected to document their reliance on such mitigating factors. The Agencies have expressly stated that higher interest rates are not an acceptable mitigating factor.

Although not prohibiting reduced documentation or stated income loans, the Statement will reduce the number of borrowers qualifying for these mortgage loan products and effectively limit the availability of this product to subprime borrowers. Over the past few months banking regulators have publicly questioned the widespread acceptance by lenders of unverified, stated income loans from subprime borrowers.⁷

Workout Arrangements

The Agencies specifically requested comment on whether the Proposed Statement would unduly restrict the ability of subprime borrowers to refinance their existing ARM loans to avoid payment shock.⁸ In response to the comments, the Agencies incorporated a section on workout arrangements in the Statement that references the principles set forth in the Interagency Statement on Working with Mortgage Borrowers (Interagency Statement).⁹ The Interagency Statement also noted that financial institutions may receive favorable Community Reinvestment Act consideration for programs that transition low and moderate income borrowers from higher to lower cost loans.

Concerned that the Statement would limit financial institutions' ability to undertake loan modifications, the Agencies expressly stated that prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. Financial institutions are expected to follow prudent underwriting practices in determining whether to consider a loan modification or a workout arrangement. The Agencies will not criticize financial institutions that pursue reasonable workout arrangements with borrowers.

CONSUMER PROTECTION PRINCIPLES

Prepayment Penalties

The Proposed Statement specifically requested comment regarding whether prepayment penalties should be limited to the initial fixed-rate period and whether an institution's providing a window of 90 days prior to the reset date to refinance without a prepayment penalty would help meet borrower needs. The Agencies were concerned that borrowers were locked into loans with high monthly payments by prepayment penalties. After considering these comments, the Agencies determined that the period during which prepayment penalties apply should not exceed the initial reset period, and that institutions generally should provide borrowers with a reasonable period of time (typically, at least 60 days prior to the reset date) to refinance their loans without penalty. There is no supervisory expectation for institutions to waive contractual terms with regard to prepayment penalties on existing loans.

The Agencies' concerns about prepayment penalties for subprime mortgage loans are not new or limited to the Statement. As part of its current review of its rulemaking authority under Section 129(l)(2) of the Home Ownership Equity Protection Act, the FRB has requested comment on several questions related to prepayment penalties.¹⁰

Consumer Disclosure

Despite comments to the contrary, the Agencies determined that, additional disclosures are needed now to ensure that consumers will receive the information they need about the material features of these loans. The Agencies have recently issued for comment proposed illustrations of the type of consumer information for subprime mortgage loans.¹¹

Many commenters expressed concerns that the Proposed Statement imposed a suitability standard on mortgage lenders. The Agencies specifically addressed this concern in the Statement by noting that there was no intent to impose any suitability standard. The clarification is important because compliance with a suitability standard would be very difficult for secondary market purchasers to verify and could possibly adversely impact the resale of loans in the secondary market. Although the Statement does not impose this requirement, Congress and some state legislatures are considering whether such a suitability standard is appropriate in the mortgage lending context. At least one

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state has enacted legislation imposing such a standard and similar legislation has been proposed in the House Financial Services Committee.¹²

The Agencies remain concerned that marketing materials may not provide consumers with enough information to make an informed decision regarding loan products.¹³ Communications with consumers, including advertisements, oral statements, and promotional materials, should provide clear and balanced information about the relative benefits and risks of the products. Consumers should receive this information in a timely manner to assist in the product selection process, not just upon submission of an application or at consummation of the loan. The information provided to consumers should clearly explain the risk of payment shock and the ramifications of prepayment penalties, balloon payments, and the lack of an escrow for taxes and insurance.

Control Systems

The Agencies expect financial institutions to develop strong control systems to monitor whether actual practices are consistent with their policies and procedures. These systems should address compliance and consumer information concerns, as well as safety and soundness, and encompass both institution personnel and applicable third parties, such as mortgage brokers or correspondents. As highlighted in previous regulatory issuances, the Agencies remain concerned about third parties involved in the origination process and the financial institutions' ability to supervise these entities.¹⁴

As part of their examination and oversight roles, the Agencies will continue to carefully review risk management and consumer compliance processes, policies, and procedures and take action against institutions that exhibit predatory lending practices, violate consumer protection laws or fair lending laws, engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound lending practices. The Agencies are expected to conduct a more detailed examination of subprime lending activities.¹⁵ Enforcement actions targeting subprime lending practices may result from this additional scrutiny. Earlier this year, the FDIC took such action against one subprime mortgage lender.¹⁶

Initial Impact of the Statement

The release of the Statement by the Agencies has directly affected several aspects of the subprime mortgage lending business. While other legislative and regulatory changes are

expected, three of the initial developments are highlighted below.

First, CSBS and groups regulating state licensed mortgage lenders have prepared model guidance for implementation by the States. Until the states adopt similar guidance, state licensed lenders will have the ability to continue offering certain loan products without regard to the restrictions in the Statement. Although state licensed mortgage lenders can continue to originate these loan products, secondary market participants have been reluctant to purchase many of these hybrid loan products. If the secondary market will not purchase these loans, it is unlikely that state licensed lenders would originate these loans even though they are not covered by the Statement or similar guidance.

Second, although not directly applicable to the GSEs, the statement will likely impact purchases and investments by Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac have indicated to their regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), that they will no longer purchase residential mortgage loans unless the loans comply with the Statement.¹⁷ In addition, OFHEO is considering whether Fannie Mae and Freddie Mac should purchase residential mortgage backed securities representing an interest in pools of mortgage loans that do not comply with the Statement. The inability or unwillingness of Fannie Mae and Freddie Mac to purchase certain loans or mortgage-backed securities representing an interest in these types of loans will reduce liquidity in this market.

Finally, although the Statement does not prohibit any type of loan product, many once common types of hybrid loans made to subprime borrowers are no longer included on lenders' product menus. For example, many lenders are no longer offering 2/28 hybrid ARM loans and drastically reducing the number of "low doc" and no income verification loans. The removal of the 2/28 hybrid ARM loan from many lenders' product lists is only partly a result of the Statement. Other factors, such as Standard & Poor's new guidance regarding the appropriate credit enhancement for these types of loans, have played a part.¹⁸ Collectively, this guidance, the Statement's requirements and the reluctance of the secondary market to purchase 2/28 hybrid ARM loans have effectively eliminated this loan product.

CONCLUSION

The Agencies worked diligently to draft and issue the Statement in an expeditious manner, but it is unlikely that this action will eliminate the calls for federal legislation in

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the subprime mortgage lending area. Over the past several months, there have been a number of regulatory initiatives in the subprime lending area and several more are on the horizon, including the FRB's current HOEPA review and rule making. While many industry participants hoped that Congress and the state legislatures would allow lenders and secondary market participants to implement the Statement and other guidance before enacting any additional laws

aimed at subprime lending, the continuing turmoil in the subprime mortgage market may spur Congressional action in the near future. Certain states have decided not to wait and have taken action. For example, Minnesota has enacted a suitability standard and North Carolina has effectively prohibited low- and no-documentation loans. The impact of these new laws on the mortgage lending markets in these states remains unclear.

NOTES

1. 72 Fed. Reg. 10533 (2007).
2. 72 Fed. Reg. 37569 (2007).
3. State Financial Regulators Issue Joint Statement On Subprime Lending (July 17, 2007). According to the CSBS release, the following 26 mortgage regulators have stated they intend to expedite implementation: Alabama, California, Connecticut, Delaware, District of Columbia, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Massachusetts, Michigan, Mississippi, Missouri, Nebraska, New Hampshire, New York, North Carolina, North Dakota, Pennsylvania, Rhode Island, South Dakota, Vermont, Washington, and Wyoming. This implementation could take up to a year in certain states.
4. Expanded Guidance for Subprime Lending Programs (2001).
5. Examples of these types of hybrid ARM loans include "2/28" and "3/27" which feature a fixed rate for two or three years and then adjust to a variable rate for the remaining three years and then adjust to a variable rate for the remaining 28 or 27 years. The initial fixed interest rate is typically lower than the fully indexed rate at origination by at least 300 basis points.
6. For purposes of the Statement, the "fully indexed rate" equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate.
7. See, e.g., remarks by John Dugan, Comptroller of the Currency before the Neighborhood Housing Services of New York (May 23, 2007).
8. 72 Fed. Reg. 10533, 10536 (2007).
9. Interagency Statement on Working with Mortgage Borrowers (April 2007).
10. 72 Fed. Reg. 30380 (2007).
11. 72 Fed. Reg. 45495 (2007).
12. Minn. H.B. 1004 (effective Aug. 1, 2007); H.R. 3081
13. The Federal Trade Commission has expressed similar concerns and recently sent letters to approximately 200 mortgage lenders warning them about their advertisements. See FTC press release dated September 11, 2007.
14. See e.g., OCC Advisory Letter 2003-3: "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans" (Feb. 21, 2003).
15. Some of the Agencies are working with the state regulators on a pilot project to conduct consumer-protection compliance reviews of selected non-depository lenders with significant subprime mortgage operations.
16. FDIC Order to Cease and Desist against Fremont Investment & Loan (March 7, 2007).
17. See Housing, Subprime and GSE Reform: Where are we headed? James B. Lockhart III, Director, OFHEO, Exchequer Club of Washington, D.C. (July 18, 2007).
18. Standard & Poor's Methodology Revisions Announced (July 11, 2007).