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NEW OCC GUIDELINES ESTABLISH ANTI-PREDATORY LENDING STANDARDS FOR NATIONAL BANKS

The New Guidelines Identify Practices That Are Disfavored or of Special Concern in Residential Mortgage Lending. They Also Provide for Enhanced Care for High-risk Consumers, Clear and Conspicuous Communications with Borrowers, and Criteria for Relationships with Intermediaries.

By Andrew L. Sandler and Andrea K. Mitchell*

On February 2, 2005, the Office of the Comptroller of the Currency ("OCC") issued new Guidelines Establishing Standards for Residential Mortgage Lending Practices (the "Residential Lending Guidelines" or "Guidelines").¹ The Guidelines, which became effective April 8, 2005, identify certain loan terms, conditions and features as inconsistent with sound loan practices and describe measures that national banks are directed to take to prevent their

involvement in predatory, abusive, unfair or deceptive residential mortgage lending practices.² The OCC issued these mortgage lending standards to ensure that "abusive lending practices do not gain a foothold in the national banking system," according to Julie L. Williams, acting Comptroller of the Currency.³ These Guidelines should be viewed by national bank mortgage lenders as a set of minimum standards that the OCC will test against in consumer examinations.

1. 12 C.F.R. Part 30, Appendix C.

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2. The Guidelines define *residential mortgage loan* as "any loan or other extension of credit made to one or more individuals for personal, family, or household purposes secured by an owner-occupied 1-4 family residential dwelling, including a cooperative unit or mobile home." For purposes of the Guidelines, the term *bank* means "any national bank, federal branch or agency of a foreign bank, and any operating subsidiary thereof that is subject to these Guidelines." 12 C.F.R. Part 30, Appendix C.
3. OCC News Release 2005-10.

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BACKGROUND

The Guidelines substantively derive from two Advisory Letters issued in February 2003 ("Advisory Letters").⁴ The Advisory Letters identified common predatory lending practices and outlined mortgage lending standards for national banks to employ in originating and purchasing loans and managing relationships with third party brokers. The Advisory Letters remain in effect and provide additional background and clarification for the principles set forth in the Guidelines.

In January 2004, the OCC issued a regulation that prohibited national banks from granting loans predominantly based on the bank's realization of foreclosure or liquidation value of the collateral without regard to the borrower's ability to repay the debt.⁵ The same rulemaking prohibited national banks from engaging in unfair or deceptive practices as proscribed by the Federal Trade Commission Act.⁶

4. OCC Advisory Letters 2003-2 and 2003-3.
5. 12 C.F.R. Part 34.
6. 15 U.S.C. § 45.

OCC GUIDELINES FOR RESIDENTIAL MORTGAGE LENDING

The Guidelines establish a set of standards for residential mortgage lending practices enforceable pursuant to Section 39 of the Federal Deposit Insurance Act⁷ and 12 C.F.R. Part 30, which establish the safety and soundness standards for national banks. The Guidelines specify additional statutes and regulations that govern various aspects of fair lending practices.⁸

The OCC's decision to set forth these standards in guidelines rather than regulations allows the agency to retain the flexibility to enforce adherence to the Guidelines on a case-by-case basis.⁹ Pursuant to 12 C.F.R. Part

7. 12 U.S.C. § 1831p-1.
8. Federal Deposit Insurance Act (12 U.S.C. § 1818); Federal Trade Commission Act (15 U.S.C. § 45); Equal Credit Opportunity Act (15 U.S.C. § 1691); Fair Housing Act (42 U.S.C. § 3601); OCC regulation governing real estate lending (12 C.F.R. § 34.3); OCC regulation governing real estate appraisals (12 C.F.R. Part 34, Subpart C); OCC regulation prohibiting lump sum, single premium fees for debt cancellation contracts and debt suspension agreements for residential mortgage loans (12 C.F.R. § 37.3(c)(2)); OCC regulation on fiduciary activities and asset management (12 C.F.R. § 9.6(a)); Interagency Appraisal and Evaluation Guidelines (OCC Advisory Letter 2003-9).
9. See 12 U.S.C. § 1831p-1(e)(1)(A)(i) and (ii). When a national bank violates a regulation, the OCC *shall* require a compliance (footnote continued on next column...)

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30, the OCC may, in its discretion, require a national bank to submit a compliance plan for failing to meet a standard prescribed by the Guidelines. Failure to submit or implement a compliance plan shall result in the OCC, by order, requiring the national bank to take the necessary corrective action. Non-compliance with an order may result in the OCC seeking enforcement of the order in district court or assessing a civil money penalty.

Standards for Residential Mortgage Lending Practices

Section II of the Guidelines sets forth the following statement generally addressing residential mortgage lending standards: “A bank’s residential mortgage lending activities should reflect standards and practices consistent with and appropriate to the size and complexity of the bank and the nature and scope of its lending activities.” In addition, this section identifies two objectives for residential mortgage lending activities of national banks. Those objectives state that a national bank’s standards and practices should enable it to: (1) manage the credit, legal, compliance, reputation and other risks associated with mortgage lending; and (2) prevent the bank from direct or indirect involvement in abusive, predatory, unfair or deceptive mortgage lending practices.

Implementation of Residential Mortgage Lending Standards

Section III of the Guidelines describes certain loan terms, conditions and features that national banks must either avoid entirely or use only in limited circumstances with prescribed safeguards; identifies categories of borrowers who are vulnerable to abusive lending practices; provides guidance on requirements for timely, sufficient and accurate communications with borrowers; prescribes appropriate measures to safeguard against abusive or predatory lending practices in purchasing loans or dealing with third party brokers; and establishes standards for compliance and evaluation efforts.

Disfavored Practices

The Guidelines state that national banks should not become involved, directly or indirectly, in the following

residential mortgage lending practices:

- Equity stripping and fee packing;
- Loan flipping;
- Refinancing special mortgages; and
- Encouragement of default.¹⁰

Practices of Special Concern

The Guidelines identify twelve additional loan terms, conditions and features that while not prohibited, are considered to be susceptible to abusive, predatory, unfair or deceptive practices under certain circumstances. The Guidelines direct national banks to “prudently consider the circumstances” before including these terms, conditions or features in a residential mortgage loan. These include:

- Financing single premium credit life, disability or unemployment insurance;
- Negative amortization;
- Balloon payments in short-term transactions;
- Prepayment penalties that are not limited to the early years of the loan, particularly for subprime loans;
- Interest rate increases upon default at a level not commensurate with risk mitigation;

10 *Equity stripping and fee packing* means “[r]epeat refinancings where a borrower’s equity is depleted as a result of financing excessive fees for the loan or ancillary products.”

Loan flipping means “[r]epeat financings under circumstances where the relative terms of the new and refinanced loan and the cost of the new loan do not provide a tangible economic benefit to the borrower.”

Refinancing of special mortgages means “[r]efinancing of a special subsidized mortgage that contains terms favorable to the borrower with a loan that does not provide a tangible economic benefit to the borrower relative to the refinanced loan.”

Encouragement of default means “[e]ncouraging a borrower to breach a contract and default on an existing loan prior to and in connection with the consummation of a loan that refinances all or part of the existing loan.” 12 C.F.R. Part 30, Appendix C.

(footnote continued...)

plan. If, however, a national bank fails to meet a standard prescribed by guideline, the OCC *may* require such a plan.

- Call provisions permitting the bank to accelerate payment of the loan under circumstances other than the borrower's default under the credit agreement or to mitigate the bank's exposure to loss;
- Absence of an appropriate assessment and documentation of the consumer's ability to repay the loan in accordance with its terms, commensurate with the type of loan;
- Mandatory arbitration clauses or agreements, particularly if the eligibility of the loan for purchase in the secondary market is thereby impaired;
- Pricing terms that result in the loan's being subject to the provisions of the Home Ownership and Equity Protection Act (15 U.S.C. § 1639 *et seq.*);
- Original principal balance of the loan in excess of appraised value;
- Payment schedules that consolidate more than two periodic payments and pay them in advance from the loan proceeds; and
- Payments to home improvement contractors under a home improvement contract from the proceeds of a residential mortgage loan other than by an instrument payable to the consumer, jointly to the consumer and the contractor, or through an independent third party escrow agent.

Enhanced Care for High-Risk Consumers

The Guidelines expressly caution national banks to exercise "enhanced care" and maintain heightened internal controls and monitoring processes with respect to use of those loan terms, conditions or features in loans to borrowers who are not financially sophisticated, have language barriers, are elderly, have limited or poor credit histories, are substantially indebted, or possess other characteristics that limit their credit choices. The Guidelines do not provide meaningful insight on the nature of the heightened diligence required with respect to such high-risk consumers.

Clear and Conspicuous Communications with Consumers

The Guidelines do, however, note the requirement that

banks provide timely, sufficient and accurate information. Banks are directed to provide information that sets forth the terms, costs, risks and benefits of the loan and draw a consumer's attention to the key terms of the loan. OCC Advisory Letter 2003-2 provides further guidance on consumer communications, stating that banks should provide borrowers with information that "enable[s] them to determine whether the loan meets their particular financial circumstances and needs."

Indirect Lending Requirements

The Guidelines provide six residential mortgage lending standards for purchasing loans or originating loans through mortgage brokers to ensure that a national bank's indirect lending practices comport with its direct lending practices. Those risk mitigation standards include:

- Criteria for entering into and continuing relationships with intermediaries and originators, including due diligence requirements;
- Standards relating to underwriting and appraisal requirements;
- Standards relating to total loan compensation and total compensation of intermediaries, including maximum rates, points, and other charges, and the use of overages and yield-spread premiums;
- Requirements for agreements with intermediaries and originators, including with respect to risks identified in the due diligence process, compliance with appropriate bank policies, procedures and practices and with applicable law (including remedies for failure to comply), protection of the bank against risk, and termination procedures;
- Loan documentation procedures, management information systems, quality control reviews, and other methods through which the bank will verify compliance with agreements, bank policies and applicable laws, and otherwise retain appropriate oversight of mortgage origination functions, including loan sourcing, underwriting and loan closings; and
- Criteria and procedures for the bank to take appropriate corrective action, including modification of loan

terms and termination of the relationship with the intermediary or originator in question.

Compliance and Monitoring Requirements

Lastly, the OCC advises national banks to monitor their compliance with applicable laws and internal mortgage lending standards on an ongoing basis. The Guidelines further establish that banks should implement measures to monitor and evaluate consumer complaints and assess the overall effectiveness of their mortgage lending standards, measured against the objectives provided in Section II of the Guidelines. Moreover, banks are directed to establish procedures for taking corrective action in response to cases of non-compliance and develop a process for revising the bank's residential mortgage lending standards. Such revisions should focus on enhancing effectiveness or effecting changes in bank activities, including modifications to a bank's business practices, market conditions, lines of business, mortgage loan programs, and customer base. OCC Advisory Letter 2003-02 specifically recommends banks conduct periodic document reviews on a random sampling of loan transactions to monitor compliance with bank policies and legal requirements and, where particular risks are identified, banks should perform a more comprehensive review.

* * *

The OCC Residential Lending Guidelines reflect the increased scrutiny of the OCC on national bank mortgage lending practices to ensure fair treatment to vulnerable "high risk" consumers. National bank lenders are well advised to ensure that their lending practices conform to the parameters set forth in the Guidelines in anticipation of vigorous consumer lending examinations. ■