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American Financial Services Association Law Committee Meeting

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OPEN-END CREDIT?

Open-End Credit?

- Mortgage banker wants to offer first lien HELOCs with a two year draw period, interest-only payments during draw period, and 28 year repayment period. Stated reason is that the lender is declining credit worthy borrowers who do not meet the ATR test.
- Bank is considering a new HELOC product with a 2 year draw period and 28 year repayment period. Stated reason is to reduce exposure to underutilized HELOC draws. Bank has found 80% of customers take their last draw by the end of year 2.
- Are these TILA-compliant or are they “spurious open-end credit”?

Open-End Credit?

- Reg Z defines open-end credit as consumer credit extended by a creditor under a plan in which:
 - **The creditor reasonably contemplates repeated transactions;**
 - The creditor may impose a finance charge from time to time on an outstanding unpaid balance; and
 - **The amount of credit that may be extended to the consumer during the term of the plan (up to any limit set by the creditor) is generally made available to the extent that any outstanding balance is repaid.**

12 C.F.R. §1026.2(a)(20)

Open-End Credit?

- Reg Z prohibits a creditor from structuring a loan as an open-end plan to evade the ATR or higher priced mortgage rule's requirements

12 C.F.R. §1026.35(d); 12 C.F.R. §1026.43(h)

- Reg Z prohibits a creditor from structuring a transaction that is otherwise a high-cost mortgage “in a form, for the purpose, and with the intent to evade the requirements of a high-cost mortgage”

12 C.F.R. §1026.34(b)

- Objective standard applied

Open-End Credit?

- One circuit court case held that a credit card provided in connection with the purchase of a satellite dish was open-end credit because the bank's expectations of repeat use of the credit card were reasonable and the credit was legitimately open-end.
- Among other data, the Bank's program showed repeat transactions on 20% of active accounts, and the credit card could be used at any of hundreds of authorized dealers of satellite dish systems and other types of electronic equipment nationwide.
- The court did not examine the issue of the replenishing line, a factor that is often questionable, given that many of these plans set the initial limit at or near the amount of the initial purchase.

Benion v. Bank One, 74 144 F.3d 1056 (7th Cir. 1998)

Open-End Credit?

- A home financing case involved a 20% home equity line second lien mortgage that would likely have been a HOEPA loan if it were a closed end loan
- While summary judgment was granted for the lender (albeit on other grounds), the court observed that exhaustion of the credit limit at origination made the transaction look more like a closed-end loan, particularly because it was part of a single transaction that was split only because of the lender's inability to issue a traditional mortgage in excess of 80% of the home value

Nelson v. JPMorgan Chase Bank, N.A., 707 F. Supp. 2d 309 (E.D.N.Y. 2009)

Open-End Credit?

- BK court held HELOC was not open-end credit (and therefore was subject to HOEPA). Same creditor issued both first closed end and second HELOC . Court highlighted: full credit limit disbursed at closing; interest-only payments for first 3 years (so no principal reduction); 3 year draw period; and limited monthly income = borrower unlikely to pay more than interest-only payments given (HELOC would not replenish).

In re Merriam, 333 B.R. 22 (Bankr. W.D.N.Y. 2005)

- Focus often on whether creditor reasonably contemplates repeated transactions.
 - Require case-by-case analysis, and it's an objective test.

QM Bill

- Senators Mark Warner (D-VA) and Mike Rounds (R-SD) recently introduced **Senate Bill 3401 (Self-Employed Mortgage Access Act)** to facilitate access to residential mortgage loans for consumers who are self-employed or otherwise receive income from non-W-2, nontraditional sources.
- If enacted, would provide alternatives to Appendix Q by:
 - permitting lenders to accept income documentation that would comply with the requirements of Fannie Mae, Freddie Mac, or a Federal Home Loan Bank, subject to the approval of the FHFA
 - permitting lenders to permit the use of income documentation that would satisfy FHA, the Department of Veterans Affairs, the Department of Agriculture, or the Rural Housing Service
 - removing the sunset date for agency Fannie Mae/Freddie Mac purchase eligibility

Guide Compliance Act

- The *Give Useful Information to Define Effective Compliance Act*, or *GUIDE Compliance Act* (HR 5534) would require the CFPB to do what the financial service industry has been asking for years - provide guidance on how to comply with consumer protection laws
- Passed by the House Financial Services Committee 38-14 on September 13, 2018
- On Sept. 17, 2018, S. 3443 was introduced as a companion to HR 5534 (and with the same name)

Guide Compliance Act

Both bills would:

- Require the CFPB to issue "guidance" necessary or appropriate to carry out the purpose of the laws for which it is responsible, including facilitating compliance;
- Require the CFPB to establish a process and timeframes for requests for guidance, including time limits to provide answers in response to requests for guidance;
- Define "guidance" to include a range of written issuances from interpretative and legislative rules, to bulletins and frequently asked questions;

Guide Compliance Act

Both bills:

- Require publication in the Fed. Reg. within one year of enactment, the definitions, criteria, timelines and process for issuing each type of guidance the CFPB shall provide, with a final rule required within 18 months of enactment;
- Prohibit liability for reliance in good faith on guidance from the CFPB or any predecessor agency that was in effect at the time of such act or omission;
- Require the CFPB to create a process for amending or revoking guidance, including a process for public notice and comment;
- Require the CFPB to develop guidelines for determining the size of any civil money penalties

Electronic Mortgages – E-Sign and UETA

- Uniform Electronic Transactions Act (UETA) – applies to state law
- Electronic Signatures in Global and National Commerce Act (E-Sign) – applies to both federal and state law (subject to preemption rule)
 - Overlay statute
 - Authorize replacing writings with electronic records
 - Authorize electronic signatures
 - Require affirmative “opt-in” by parties - with UETA, opt-in may be shown by surrounding circumstances
- States not signed up for UETA - New York, Illinois, and Washington

Electronic Mortgages – Retention of Electronic Records

- Both E-Sign and UETA permit copies of contracts and state and federal disclosures to be retained electronically, provided the contract or other record:
 - Accurately reflects the information set forth in the contract or other record
 - Remains accessible to all persons who are entitled to access by statute, regulation, or rule of law, for the period required by statute, regulation, or rule of law, in a form that is capable of being accurately reproduced for later reference, whether by transmission, printing, or otherwise

Electronic Mortgages – Retention of Electronic Records

- Document integrity
 - Is what is stored that which was originally generated?
 - Are unauthorized modifications and changes prevented, and are authorized changes tracked appropriately?
- Technology changes – need to consider migration to new technologies
- Failure to retain can
 - Impair enforceability
 - Result in failure to satisfy regulatory writing, delivery or signing requirements
 - Result in admissibility in court

Electronic Mortgages - eRecording

- Only nine states are 100% eRecording-enabled (Alaska, Arizona, Colorado, Delaware, District of Columbia, Hawaii, Iowa, Oregon, Massachusetts)
- States with no eRecording: Kentucky, Rhode Island, Vermont, West Virginia
- Nearly 1,800 counties nationwide (out of approximately 3,100)
- Approximately 80% of US population covered

Electronic Mortgages - eNotarization

- Issue is one of remote notarization, where signor and notary are not in the same office
 - Done via Skype, video, or audio conferencing
- A fraction of 1% of the 10 million mortgage closings executed in the U.S. in 2016 were true eMortgages
- As of late 2017, the only states with laws to permit the presence of a notary to be established over video and audio were Ohio, Nevada, Texas, and Virginia

Electronic Mortgages – Other Issues

- Not all investors will accept eMortgages
 - Fannie and Freddie will, subject to compliance with detailed requirements
 - Other investors are all over the board
- Transferable record issue – electronic document equivalent of a negotiable instrument

Safety and Soundness - The Compliance Conundrum

- In regulated industry like residential mortgage lending, companies must always balance regulatory and business considerations. Not always clear up front whether a proposed business plan or method of implementing a business objective complies with applicable law. At some point compliance risk becomes enterprise risk, but where do you draw the line?
- Even in an era of lower government enforcement, the analytical framework is the same.

Safety and Soundness - The Compliance Conundrum

- A company can not engage in risk-based compliance in isolation, because the availability of financing, investor take-outs and even the ultimate ability to sell the company can be adversely impacted by others who may evaluate risk differently.

Beyond the Specifics of Federal or State Consumer Credit Laws, What Can You Do to Strengthen Operations from a Compliance Perspective?

- Prepare for extension of federal banking “safety and soundness” principles to state chartered, non-depository mortgage companies.
- As an example, adopt a program to address potential sales practices misconduct.

Should State-Chartered, Non-Depository Mortgage Companies Adopt Basic “Safety and Soundness” Principles of the Type to which Federally-insured Banks are Subject?

- Federal law requires each Federal banking agency to establish certain safety and soundness standards by regulation or by guideline for all insured depository institutions, based on three types of standards: (1) *operational and managerial standards*; (2) compensation standards; and (3) such standards relating to asset quality, earnings, and stock valuation as they determine to be appropriate.
- Essentially, can it withstand fluctuations in the economy and does it have weaknesses that require correction?

Should State-Chartered, Non-Depository Mortgage Companies Adopt Basic “Safety and Soundness” Principles of the Type to which Federally-insured Banks are Subject?

- With respect to the first standard, the federal banking agencies jointly have issued Interagency Guidelines Establishing Standards for Safety and Soundness, which include:
 - **Internal controls and information systems.** An institution should have internal controls and information systems that are appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for:
 - An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to established policies;
 - Effective risk assessment;
 - Timely and accurate financial, operational and regulatory reports;
 - Adequate procedures to safeguard and manage assets; and
 - Compliance with applicable laws and regulations.

Should State-Chartered, Non-Depository Mortgage Companies Adopt Basic “Safety and Soundness” Principles of the Type to which Federally-insured Banks are Subject?

- **Internal audit system.** An institution should have an internal audit system that is appropriate to the size of the institution and the nature and scope of its activities and that provides for:
 - Adequate monitoring of the system of internal controls through an internal audit function.
 - Independence and objectivity;
 - Qualified persons;
 - Adequate testing and review of information systems;
 - Adequate documentation of tests and findings and any corrective actions;
 - Verification and review of management actions to address material weaknesses; and
 - Review by the institution's audit committee or board of directors of the effectiveness of the internal audit systems.

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- The Office of the Comptroller of the Currency’s (OCC) *Comptroller’s Handbook* booklet, *Corporate and Risk Governance* (the “OCC Booklet”), specifies eight categories of risk for bank supervision purposes: **credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation.**
 - In terms of basic risk management, the OCC looks to both corporate governance and risk governance. The former is described in the OCC Booklet to involve the relationships among the bank’s board, management, shareholders, and other stakeholders for governing the bank’s operations and structure. The latter is described in the OCC Booklet as the application of the principles of sound corporate governance to the identification, measurement, monitoring, and controlling of risks to ensure that risk-taking activities are in line with the bank’s strategic objectives and risk appetite. Risk governance is the bank’s approach to risk management and includes the policies, processes, personnel, and control systems that support risk-related decision making.

Should State-Chartered, Non-Depository Mortgage Companies Adopt Basic “Safety and Soundness” Principles of the Type to which Federally-insured Banks are Subject?

- State mortgage banking departments increasingly are looking at governance and risk management controls in their audits of licensees. New York, for example, includes the following in its Mortgage Banker Guidebook in Section IV, Supervisory Oversight-Evaluation of Rating Components, relating to mortgage origination activities:
 - “Strong internal controls are essential to a licensee’s risk management. Policies and procedures are an integral part of a sound internal control environment. Licensed mortgage bankers should ensure that policies provide personnel with a consistent message regarding unauthorized activity, malfeasance, loan documentation standards and overall conduct with consumers. Furthermore, management should establish appropriate control systems and monitoring functions to ensure compliance with internal policies and procedures.

Should State-Chartered, Non-Depository Mortgage Companies Adopt Basic “Safety and Soundness” Principles of the Type to which Federally-insured Banks are Subject?

- The internal control system should employ controls that are both preventative and detective. Preventative controls are designed to discourage noncompliant and fraudulent behavior, while detective controls facilitate the identification of noncompliant and fraudulent behavior after they have occurred.
- Mortgage bankers should maintain a system of controls appropriate for the size, complexity and associated risk of its origination activities. Internal controls should employ front-end policies and procedures to prevent unauthorized activity, fraud and financial loss, and back-end detective measures to identify errors, unauthorized activity and fraud. Detective measures could include quality control reviews, management information systems reports, internal or external audits and information technology reviews.”

Should State-Chartered, Non-Depository Mortgage Companies Adopt Basic “Safety and Soundness” Principles of the Type to which Federally-insured Banks are Subject?

- More broadly, look at the New York Department of Financial Services’ Cyber-Security Requirements for Financial Services Companies (23 NYCRR 500). Licensees must maintain a cybersecurity program designed to protect confidentiality, integrity, and availability of a covered entity’s information system, including periodic risk assessments.
- In many cases, the states do not have specific regulatory requirements for internal audit and risk management, but that doesn’t stop them for looking for such controls. Reviews are not as robust as with federal banking regulators, often because there are no explicit regulatory standards but are derived from a government’s authority to evaluate the “character and fitness” of a licensee. That might be changing.

Should State-Chartered, Non-Depository Mortgage Companies Adopt Basic “Safety and Soundness” Principles of the Type to which Federally-insured Banks are Subject?

- Early this past summer, Rep. Maxine Waters proposed the “Homeowner Mortgage Servicing Fairness Act of 2018” (the “Proposed Act”), which empowers the Federal Housing Finance Agency (“FHFA”) to promulgate standards by regulation for “covered servicers.”
 - The standards required to be promulgated are set forth in Section 3 of the Proposed Act include:
 - Adequacy of internal controls and information systems, taking into account the nature and scale of business operations;
 - Independence and adequacy of internal audit systems;
 - Overall risk management processes, including adequacy of oversight by senior management and policies to identify, measure, monitor, and control material risks, including data protection and reputational risks.
 - Such other operational and management standards as the Director determines to

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 - Such other operational and management standards as the Director determines to be appropriate to carry out the purposes of the Proposed Act.

Should State-Chartered, Non-Depository Mortgage Companies Adopt Basic “Safety and Soundness” Principles of the Type to which Federally-insured Banks are Subject?

- Derived from federal banking regulations, these provisions are the same ones to which the GSEs are subject under FHFA supervision. The Proposed Act simply extends the requirements to seller/servicers.
- The Proposed Act mandates the FHFA both to conduct oversight of “covered servicers” on a regular and ongoing basis and in a manner designed to ensure that such servicers comply with the Proposed Act’s requirements and any related regulations issued by the FHFA and to identify systemic problems and trends with such compliance.
- Note that the draft GSE reform bills circulated earlier this year by Senators Corker and Warner do not include this concept and explicitly provide that FHFA has no authority to supervise seller/servicers.

Should State-Chartered, Non-Depository Mortgage Companies Adopt Basic “Safety and Soundness” Principles of the Type to which Federally-insured Banks are Subject?

- Nevertheless, even if not yet required by law or regulations, it increasingly looks like state chartered, non-depository mortgage companies should consider evaluating the applicability of basic safety and soundness principles to their operations.

Watching for Sales Practices Misconduct

- What do we mean by sales practices misconduct?
 - Used by regulators to describe a wide-range of deceptive, misleading, or unethical sales activities driven by production goals, sales incentives, or sales pressure.
 - The term is often defined based on the specific conduct deemed by regulators to be unlawful.
- Not sales practices that relate to the following types of activities:
 - Activities that are expressly regulated and covered by other consumer financial laws (for instance, anti-kickback requirements under RESPA).
 - Questions of suitability or the relative adequacy/fairness of any particular product for an individual consumer.
 - Post-sale administration or servicing.

Minimizing Sales Practices Risks

- Evaluating the impact of numerical sales goals/quotas
- Emphasizing customer satisfaction over sales
- Watching for undue pressure on sales targets
- Enhancing third-party vendor management and oversight
- Developing strong sales practices governance program

Elements of a Sales Practice Governance Program

Tone at the Top and Culture to Drive Appropriate Behaviors

- Mission or strategy statement setting forth sales practice strategy
- Distributing mission statement to all employees and employee attestation to statement
- Surveys to ensure tone at the top is understandable and reaching employees
- Messaging consistent across key corporate documents, including mission statement, code of ethics, and practice manuals

Board and Executive Management Oversight

- Board providing management clear mandates for risk management functions
- Board and management setting risk limits
- Consider office with enterprise-wide authority over sales practices
- Consider enterprise-wide sales practices risk governance document

Incentive Compensation and Performance Management Plans

- Conducting periodic risk reviews of existing incentive plans and performance management plans
- Conducting risk reviews of each new incentive plan and performance management plan
- Risk reviews involving the second and third lines of defense

Monitoring, Tracking, and Escalating Complaints

- Tracking consumer complaints
- Capturing and recording complaints in a consistent manner across all lines of business to allow for enterprise-wide complaints aggregation and analysis
- Categorizing and analyzing complaints related to sales practices or UDAAP issues
- Clear policies and procedures for escalation of complaints
- Training on complaints process

Employee Allegations and Misconduct

- Clear policies and expectations for employees to report misconduct
- Confidential channel for employees to report misconduct (e.g., a “whistleblower” hotline)
- Monitoring employee confidence in hotline
- Escalation procedures
- Training employees on how to report misconduct

Customer Consent

- Clear policies and procedures for obtaining consent
- Maintaining records/evidence of consent

Potential Tools For Monitoring, Testing, and Appropriate Corrective Action

- Sales and service risk reviews for retail employees, including unannounced qualitative reviews and interviews with sales associates
- Call monitoring
- Key Risk Indicators
- Mystery shopping
- Customer surveys
- Audit

Using Data Analytics

- Utilize data-driven metrics in regular reporting
- Examples:
 - Employee turnover
 - Spikes/trends in sales
 - Incentive payouts
- Call monitoring example – using voice to text transcription and key word searches to identify and aggregate risk indicators

Reporting to Board and Management

- Policies and procedures to capture, aggregate, and report on risks to Board and senior management
- Streamlined reporting without data overloads
- Reporting indentifying issues and trends through data and plain-English analysis

Training

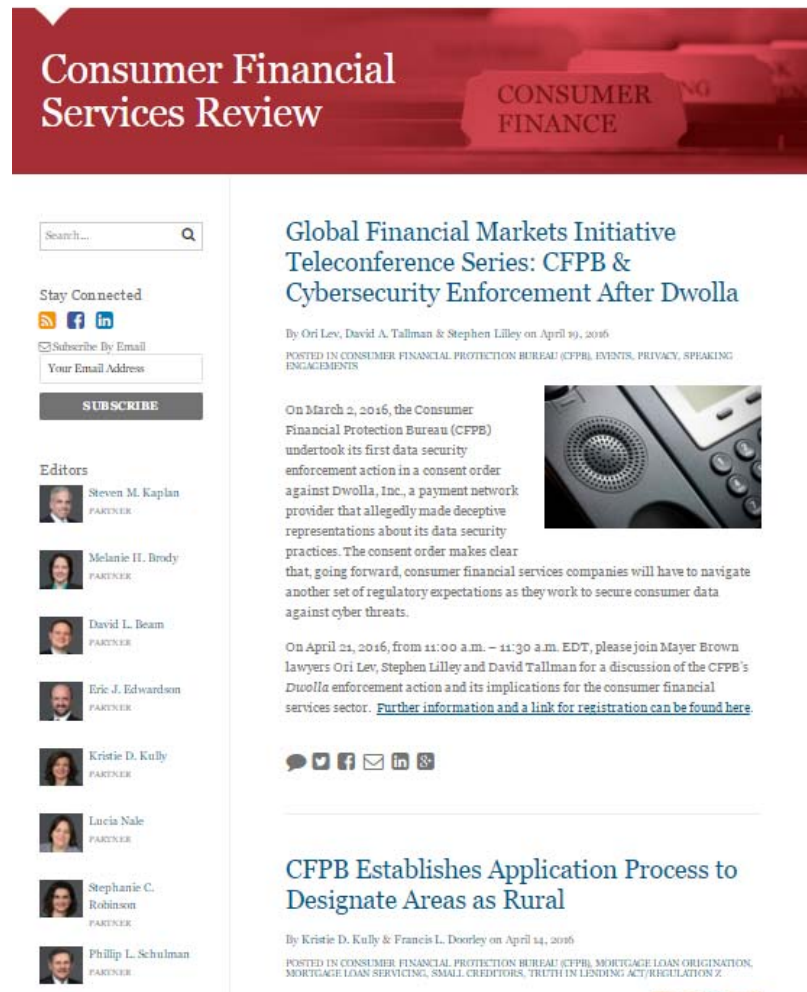
- Training content including ethics (code of conduct, escalation, corrective action) and product-specific training
- Consistent sales practice training across the enterprise
- Training content including concrete examples to help employees understand appropriate behavior and misconduct
- Training programs with comprehension checkpoints and a final assessment
- Tracking employee completion of training
- Providing dedicated time for employees to complete training

Our Consumer Financial Services Review Blog

Topics examined include:

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- Consumer Litigation
- Events
- FinCEN
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- Mortgage Loan Origination
- Mortgage Loan Servicing
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Global Financial Markets Initiative Teleconference Series: CFPB & Cybersecurity Enforcement After Dwolla

By Ori Lev, David A. Tallman & Stephen Lilley on April 29, 2016

POSTED IN CONSUMER FINANCIAL PROTECTION BUREAU (CFPB), EVENTS, PRIVACY, SPEAKING ENGAGEMENTS

On March 2, 2016, the Consumer Financial Protection Bureau (CFPB) undertook its first data security enforcement action in a consent order against Dwolla, Inc., a payment network provider that allegedly made deceptive representations about its data security practices. The consent order makes clear that, going forward, consumer financial services companies will have to navigate another set of regulatory expectations as they work to secure consumer data against cyber threats.



On April 21, 2016, from 11:00 a.m. – 11:30 a.m. EDT, please join Mayer Brown Lawyers Ori Lev, Stephen Lilley and David Tallman for a discussion of the CFPB's Dwolla enforcement action and its implications for the consumer financial services sector. [Further information and a link for registration can be found here](#)

CFPB Establishes Application Process to Designate Areas as Rural

By Kristie D. Kully & Francis L. Doorley on April 14, 2016

POSTED IN CONSUMER FINANCIAL PROTECTION BUREAU (CFPB), MORTGAGE LOAN ORIGINATION, MORTGAGE LOAN SERVICING, SMALL CREDITORS, TRUTH IN LENDING ACT/REGULATION Z

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