Guest Commentary

The Financial Services Reform Act: Leading or following enhanced consumer protection?

By Andrew L. Sandler*

The financial crisis spawned by the confluence of rapid real estate price appreciation and easy mortgage credit paved the way for The Wall Street Reform and Consumer Protection Act, HR 4173 (aka the Dodd-Frank Reform Act), now on the cusp of enactment. The new legislation is rooted in the principles set forth in the Obama Administration's June 2009 white paper on rebuilding financial supervision and regulation, to which both houses of Congress have added their own ideas.

While Congress has been negotiating the bill into compromise legislation, the financial services industry, investors, federal and state regulators, and courts have begun changing the process and rules by which consumer financial products will be financed and delivered. The legal structure captured in the Reform Act, crafted to address the last crisis, will be implemented with respect to a consumer lending industry whose practices already are somewhat different than those the law was designed to address.

Perhaps the most significant consumer financial product reforms concern home mortgages. The availability, distribution and terms for home mortgages, the products at the heart of the housing and financial crisis, have radically changed since 2007. Federal and state regulations applicable to mortgage lending and servicing practices have tightened considerably. The more exotic subprime loans that precipitated much of the crisis no longer exist.

Moreover, the number of lenders making home loans is far fewer, resulting in a significant concentration within the mortgage lending industry and a much greater proportion of loans made by banks as a result of the virtual demise of the non-bank mortgage company lending model. These developments have fostered a far less risky industry with tighter controls and a concomitant reduction in mortgage credit availability, particularly for credit-impaired borrowers.

Changes in credit policy

The evolution in subprime lending is the most telling example of the changes in credit policy caused by the mortgage meltdown. In a 2004 speech, a former Federal Reserve Board governor credited the "whopping" 25 percent annual rise in the rate of subprime mortgage originations from 1994-2003 as a significant contributor to increasing homeownership from 64 percent to more than 68 percent during the same period. Today, subprime lending is considered a root cause of the financial crisis, and lenders have markedly reduced the availability of these and other non-traditional loans, often with restricted terms, such as capped broker fees in response to high default rates.

A significant tightening of subprime mortgage underwriting standards beginning in mid-2007 has been reported by the Federal Reserve Bank of Dallas. By October 2007, more than 40 percent of the lenders polled had tightened underwriting for their prime rate mortgages as well. Lenders with lax underwriting, both depository and non-depository, have exited the business, either by merger with stronger institutions, or by insolvency. The decreasing number of lenders resulted in less available credit, particularly riskier credit.

Increased federal oversight of mortgage brokers

Another pre-Reform Act development contributing to greater consumer protection is comprehensive federal registration of mortgage brokers. Mortgage brokers and loan originators, intermediaries between consumers and financial institutions, have been criticized for promoting various "exotic" loans, including the use in subprime lending of "no-doc" loans during the housing boom. Some have also been charged with complicity in exaggerating borrower income and assets on applications for so-called "liar loans."

The federal Secure and Fair Enforcement for Mortgage Licensing Act of 2008 established a national licensing and registration system for mortgage brokers, with requirements for broker education, testing, and personal background checks. These barriers to entry into consumer mortgage brokerage are likely to reduce the number of loan originators without training or experience, as well as those with criminal or otherwise questionable personal histories.

A declining number of active mortgage brokers nationwide suggests that raising the bar to entry is working – membership in the National Association of Mortgage Brokers has declined from about 25,000 at the height of the mortgage boom to under 9,000 today. Many lenders are shying away from doing business with mortgage brokers entirely while others have sharply reduced the number of brokers from whom they accept applications.

The view from the States

State legislatures and banking agencies have been reining in risky or noncompliant behavior by mortgage brokers through various types of laws. Among these are increased surety bonds associated with occupational licenses, beefed up penalties for misleading or deceptive loan marketing practices, and in some states, adding fiduciary duties to a mortgage broker's responsibilities in loan transactions.

Since the onset of the financial and housing crisis, for example, California, Minnesota, Nevada and New Mexico have all passed laws that establish a mortgage broker's

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Andrew L. Sandler, cochair of BuckleySandler LLP, is a recognized leader in financial services enforcement and litigation. He represents banks, financial services companies, and mortgage lenders, among others in civil and criminal investigations by federal and state regulatory and enforcement agencies. Reach him at *asandler@buckleysandler.com*. ❑

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fiduciary responsibility toward his client. This responsibility is more stringent than the Reform Act's corresponding provisions on mortgage brokers, which amend the Truth in Lending Act by requiring that loan originators adhere to a "duty of care." State adoption of fiduciary duty laws demonstrates that state legislators are not sitting idly by, waiting for passage of the Reform Act.

State licensing laws are also being amended and enlarged to include individuals previously not considered loan originators, such as those engaged in processing activities (loan file processors and underwriters), loan servicing activities (including personnel handling loan modifications) and servicers themselves. Dozens of state laws have been enacted to regulate the practices of foreclosure consultants, loan modification consultants, and others who were previously outside the scope of mortgage industry regulation and licensing. These new laws allow state regulators to monitor, supervise and sanction a wide swath of individuals in the financial service industry. State appraisal laws have already been adopted in many states, and some have the added proviso that a lender may not condition an appraisal assignment on the appraiser's conclusion of a predetermined value.

Lending discrimination targeted

The Reform Act creates a new Office of Fair Lending and Equal Opportunity and otherwise seeks to advance fair and non-discriminatory lending practices. However, regulatory and enforcement agencies are not waiting for implementation of the Reform Act to move forward on this important public policy objective. The Department of Justice, having significantly beefed up its fair lending enforcement capabilities, has indicated there will be a significant increase in the number of fair lending cases it will investigate and prosecute in the coming months. These new cases will be in addition to the 38 fair lending discrimination cases initiated in the first year of the Obama Administration.

Other federal agencies likewise are actively pursuing fair lending complaints. In 2008, the FTC settled claims of lending practices violating the Equal Credit Opportunity Act with a lender whose loan officers had wide discretion to add overages to interest rates, which were said to result in higher prices for African-American and Hispanic borrowers. In 2010, the same lender was ordered to hire an outside consultant to ensure it does not offer higher-priced loans to African-Americans and Hispanics.

States, too, have become proactive enforcers of fair lending, with highly publicized lawsuits filed in Ohio and Massachusetts against lenders claimed to have engaged in predatory lending or discriminatory conduct. The Massachusetts attorney general has been particularly aggressive in challenging perceived unlawful discrimination. As a result of a suit filed against a major company and its mortgage lending subsidiary, the subsidiary was enjoined from foreclosing on Massachusetts borrowers based on alleged discrimination against African-American and Latino borrowers at loan origination. New York's attorney general, initially rebuffed in his request to obtain loan pricing and policy data from a group of national banks, took the state's claim all the way to the Supreme Court in an effort to enforce New York's fair lending laws. Other state regulators appear increasingly likely to seek to enforce their own fair lending laws, regardless of the lender's charter status.

Congressional hearings on the Reform Act suggest there may be some fine-tuning of legal principles governing federal preemption of state lending laws for national banks and their subsidiaries. One persistent argument in favor of consumer financial product oversight by a federal agency is that national banks have avoided state lending regulation based on preemption, with adverse consequences for consumers. Another is that non-bank subsidiaries of national banks, while benefitting from federal preemption to the same extent as their parent banks, are not examined for consumer compliance.

It is expected that the Reform Act will pare down federal preemption of state laws, but erosion of federal preemption is already occurring in the courts and by regulatory agencies. In particular, a recent New York case chips away at the extent of preemption available to national banks (in the context of a bank's real estate appraisal management activities). In *People v. First Am. Corp.*, 2010 NY Slip Op 04868 (N.Y. App. 1st Dept. 06/08/10), the New York Court considered whether OTS regulations under the Home Owner's Lending Act and the Financial Institutions Reform, Recovery and Enforcement Act preempt state regulations in the field of real estate appraisal. It concluded they do not.

The road ahead

The hearings on the Reform Act, particularly those sessions that focused on the future authority of existing and new regulatory bodies, were peppered with accusations that the federal financial regulatory agencies were not alert to the risks undertaken by financial institutions in the lead-up to the housing crisis. Some in Congress expressed skepticism that the same agencies, even if further empowered by regulatory restructuring, have a genuine commitment to consumer protection.

As a result, the Reform Act provides for the creation of a new Consumer Financial Protection Bureau. How the new bureau will evolve is unknown at this point, but undoubtedly, its implementation will be a labor-intensive and time-consuming process. It will be some time before the new bureau will impact the delivery of consumer financial services.

Enactment of the Reform Act and establishment of a functional consumer financial protection agency will usher in a transformation in the consumer finance world. However, given today's already proactive approach to process change by the lending industry and the regulatory community, it is less clear how greatly the Reform Act and associated regulatory apparatus will transform consumer protection and with what effects on financial product availability and the cost of consumer credit. ❑

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