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Mortgage Banking & Consumer Credit Alert

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New York Opens the New Year by Targeting Mortgage Brokers For Fair Lending Violations

New York financial services regulators welcomed the new year by announcing a "groundbreaking" agreement with two mortgage brokers in which the brokers settled fair lending charges by adopting, among other things, a standard fee schedule that appears to limit or prevent borrowers from negotiating fees paid to brokers.

The New York Attorney General ("AG") announced on January 5, 2009, the results of a "landmark investigation" by the AG and the Department of Banking "into discriminatory practices in the mortgage brokerage industry." Two targets of the investigation, HCI Mortgage ("HCI") and Consumer One Mortgage ("Consumer One"), agreed to far-reaching settlements that included: (a) adopting standard fee schedules that must be followed "unless exceptional circumstances exist;" (b) instituting internal fair lending monitoring programs of broker fees; (c) paying restitution to borrowers; and, (d) providing reports to the AG. The AG also filed suit against another target of the investigation, U.S. Capital Funding, LLC.

Mortgage Brokers: A New Target of State Fair Lending Enforcement Actions?

In targeting mortgage brokers, the settlements depart from recent fair lending enforcement actions, including a Federal Trade Commission settlement (a copy of K&L Gates' client alert on this settlement is available at http://www.klgates.com/newsstand/Detail.aspx?publication=5197), which had largely focused on mortgage lenders. Indeed, if other regulators follow New York's lead and pursue similar cases against brokers, 2009 may result in significant increases in fair lending enforcement activity. Compounding the noteworthiness of the AG's enforcement target is the remedy agreed to in the settlements. By requiring that HCI and Consumer One adopt a standard fee schedule, the AG took an aggressive stance that may significantly curtail the ability of borrowers to negotiate the specifics of broker compensation.

Allegations Limited to Up-Front Fees

In both the Consumer One and HCI settlements, the AG claimed the brokers violated the federal Fair Housing Act and New York State Human Rights Law by charging African-American and Latino borrowers higher "Broker Fees" than white borrowers in New York State. Under both settlements, Broker Fees are defined to exclude yield spread premiums. According to the settlement documents, on first-lien loans, Consumer One charged African-American borrowers on average about $1,810 more in Broker Fees than white borrowers, and Latino borrowers about $1,340 more in Broker Fees than white borrowers. The alleged Broker Fee disparities for HCI were higher—$2,260 for African-American borrowers and $2,680 for Latino borrowers. It is unclear whether these alleged disparities would have been present or different in magnitude if the AG had analyzed total broker compensation, *including* yield spread premiums.

Standard Broker Fee Policy

The requirement that both HCI and Consumer One adopt a "Broker Fee Policy" is among the more significant elements of the settlements. In each settlement, the Broker Fee Policy consists of a fee schedule (which must be posted on the broker's web site and in all branches

and offices) containing three components: a Standard Processing Fee, a Standard Application Fee, and a Standard Broker Service Fee. The HCI and Consumer One settlements treat the first two fees in an identical manner. Specifically, in both instances the fees must be expressed as a lump sum, and deviations from the standard fees are only allowed under "exceptional circumstances" that must be documented in the loan file and approved, in writing, by the branch manager. The settlements provide two examples of such exceptional circumstances: "identification of a cloud on the property's title" and "a change in the condition of the property that affects its estimated value." While these examples appear to be merely illustrative, it is not clear what other circumstances could be characterized by the AG as "exceptional."

In both settlements, the term "Standard Broker Service Fee" essentially entails all up-front fees unrelated to processing and application. For both settlements, the Standard Broker Service Fee must be expressed in the fee schedule as a percentage of the loan amount and may vary for different loan amount ranges and for different types of loans that require more work by the broker (*e.g.*, non-conforming mortgage loans, adjustable rate mortgage loans). Beyond these similarities, however, the two settlements vary in allowable departures from the Standard Broker Service Fee.

For Consumer One, the settlement authorizes downward-only departures from the Standard Broker Service Fee "if such a fee reduction is necessary to compete with an offer made to the customer by another mortgage brokerage company that is in writing and presented to Consumer One." This limitation appears to recognize that competition can be important in establishing loan level broker compensation, but arguably constrains to specific circumstances Consumer One's ability to respond to borrower negotiation. For example, if a borrower verbally indicates that he/she has a competing offer, but does not present proof of the offer in writing, the settlement would not permit Consumer One to reduce its fee to keep the deal. Moreover, the Consumer One settlement imposes a novel recordkeeping and disclosure obligation. Specifically, the settlement requires for every loan, regardless of any departure from the Standard Broker Service Fee, that the company document in the loan file the services performed in connection with the loan and, more notably, the "amount of time the [b]roker spent working on each task performed in connection with the [l]oan." In this regard, Consumer One must "disclose in writing to the consumer the total amount of time spent arranging the [l]oan."

For HCI, the AG appears to have taken a different stance and authorizes departures of up to 20 percent in the Standard Broker Service Fee where the "nature of the mortgage brokerage services provided in connection with the [loan at issue] is substantially different from the services provided in connection with similar [l]oans ... ." In this regard, the HCI settlement requires HCI to document in the loan file: "(i) the services provided in connection with the [l]oan; (ii) why such services justify a departure from the Standard Broker Fee; and (iii) the amount of time the [b]roker spent working on each task performed in connection with the [l]oan." Absent from this discussion of allowable departures, however, are instances where the borrower presents to HCI a loan offer from another broker (or lender) that contains lower up-front fees. This absence is remarkable for two reasons. First, the AG expressly authorized downward departures based on competition in its settlement with Consumer One. Second, by only authorizing departures from HCI's standard schedule based on variations in the nature of services provided, the settlement appears to prohibit any direct negotiation between HCI and a borrower concerning up-front fees.

The AG also authorized in the HCI settlement a small category of allowable downward departures from the Standard Broker Service Fee. Specifically, the settlement provides that where a "customer clearly expresses a desire to pay a higher yield spread premium, which will result in a higher APR for the [l]oan, in exchange for paying a Broker Service Fee lower than the Standard Broker Service Fee" HCI may, with specified additional disclosures, depart from the Standard Broker Service Fee.

Monitoring

Both settlements require the brokers to monitor for Broker Fee disparities. The monitoring requirements contain a number of noteworthy elements. First, under both agreements, "appropriate follow-up action" is required if there is a statewide or branch office Broker Fee disparity <u>of more than 20 basis points</u> for African-American or Latino borrowers. It is unusual for a settlement agreement to spell out specific basis point or dollar amount thresholds requiring responsive action. The mortgage lending industry has struggled with

establishing monitoring thresholds, and regulators have been reticent to provide specific guidance on the issue. Although the AG's settlements with Consumer One and HCI provide a benchmark threshold for consideration, establishing monitoring thresholds requires an analysis of a variety of factors. Lenders and brokers will still need to evaluate carefully their specific circumstances when setting price monitoring thresholds.

The monitoring provisions in both settlements require the brokers to make refunds to applicable borrowers if their average statewide disparities for African-American or Latino borrowers exceed 30 basis points. Again, the lending industry has long struggled with whether refunds based on statistical disparities are advisable. On the one hand, certain regulators now require their institutions to make refunds in such cases, and many industry members believe that issuing refunds is appropriate and more cost effective than expending the time and resources to seek explanations for statistical disparities. On the other hand, while statistical disparities can signal the presence of potential fair lending risk, most fair lending practitioners agree that statistics alone—without further investigation—should not be viewed as proof of discriminatory conduct. As a result, and for a number of other reasons, many are reticent to issue refunds based on statistical disparities alone.

Finally, the HCI settlement provides that the broker shall not be required to issue refunds if the Broker Fee disparities can be "fully explained" through statistical regression analyses that control for race- and ethnic-neutral characteristics that could potentially impact the amount of time and effort that the broker takes to arrange loans. The settlement spells out the control factors that may be used in such analyses: loan amount, whether the loan is non-conforming, loan purpose, credit score, debt-to-income ratio, loan-to-value ratio, lien status, documentation level, property type, loan date, occupancy status, number of applicants, and employment status. This is noteworthy in that it reflects at least one enforcement authority's views on appropriate control factors in broker compensation models.

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Although not binding on parties other than Consumer One and HCI, the AG's settlements provide useful insights into how New York's current attorney general views the application of fair lending laws to mortgage broker compensation. If you have any questions about the AG's settlements, please contact Melanie Brody, Paul Hancock, David McDonough or any other member of K&L Gates' mortgage banking and consumer finance group.

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