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Multi-State Mortgage Examinations are Coming. You Need to be Ready.

On March 24, 2010 the Conference of State Bank Supervisors (“CSBS”) and the American Association of Residential Mortgage Regulators (“AARMR”) announced a 35 state settlement with one mortgage company following an examination led by the Massachusetts Division of Banks of compliance with federal and state consumer protection laws. The violations that served as the basis for the settlement involved federal requirements (failing to report loans as required by the Home Mortgage Disclosure Act (“HMDA”)) and the penalties imposed (\$1.25 million) were a wake-up call. This settlement is significant as it represents one of the first joint actions of state banking departments against a state regulated mortgage lender.

In a time when mortgage lenders are already overburdened with new regulatory requirements, news of a multi-state settlement is hardly welcome. Nevertheless, it should serve as a reminder that, although multi-state mortgage examinations are being undertaken only in a pilot program today, multi-state mortgage examinations of state licensed mortgage lenders will become more frequent beginning in 2011. That is when lenders will be expected to provide 100% loan portfolio uploads to state regulators.¹

This is not new news. We previously reported that multi-state examinations were imminent in our November 2, 2009 Webinar, “The Multi-State Mortgage Examinations and Potential Enforcement Actions.” These multi-state mortgage examinations result from a newly formed commitment by the regulators in all 50 states, the District of Columbia, and Puerto Rico to coordinate their compliance reviews. This Client Alert discusses the multi-state examination process, what you can expect from a multi-state mortgage examination, and how you can prepare for these new mortgage examinations.

The Multi-State Examination Process

The multi-state examination process is the collaborative initiative of CSBS and AARMR, two groups of state regulators. Together, they have embarked on a comprehensive initiative to modernize the regulatory components of the examination process, bringing to it greater uniformity, focus, and effectiveness.

The foundation of their examination initiative is the CSBS/AARMR Nationwide Cooperative Protocol and Agreement for Mortgage Supervision (“Agreement”). The genesis of this Agreement is found in two documents that CSBS and AARMR released in December 2007, and amended in 2009, which set forth the framework for this collaborative process, the Nationwide Cooperative Protocol for Mortgage Supervision, and the Nationwide Cooperative Agreement for Mortgage Supervision.² Agencies in each state, the District of Columbia, and Puerto Rico have signed on to the Agreement.

The goals of the Agreement are to:

- protect consumers;
- ensure the safety and soundness of multi-state mortgage entities (“MMEs”), mortgage companies operating in more than one state;³
- identify and prevent mortgage fraud;
- supervise and examine in a seamless, flexible, and risk-focused manner;
- minimize regulatory burden and expense; and
- foster consistency, coordination, and communication among state regulators.

Multi-State Mortgage Committee

The head of this collaborative effort is a ten member Multi-State Mortgage Committee (“MMC”), comprised of five state regulators chosen by CSBS and an equal number by AARMR. Currently, John Prendergast, Chief Risk Officer for the Massachusetts Division of Banking, chairs the MMC.⁴

Under the Agreement, the MMC has responsibility for:

- establishing procedures for operations;
- identifying MMEs for examination;
- setting examination schedules;
- managing a nationwide examiner pool;
- staffing multi-state examinations;
- reporting;
- examination oversight; and
- coordination of multi-state examinations.

The focus of this Agreement is the sharing of resources and information among the states. Each state has the authority to examine licensees under its licensing law (and impose penalties for violations). The states have agreed to share the examination burden and information to reduce the need for regulatory resources, make better use of their existing examination resources, and target examinations where they are most needed. The stated purpose of the multi-state examination

process is to allow the states to assign greater resources to those lenders that pose a more significant risk based upon the loan data reviewed, with fewer resources dedicated to lenders that exhibit less risk.

To make the process work, the MMC will establish a pool of state examiners to review MMEs under the direct supervision of an Examiner-in-Charge (“EIC”). This pool of state examiners is expected to have a uniform skill set as the MMC is providing them with training and a uniform examination manual.⁵ An examination will be conducted by multiple examiners from one state or examiners from multiple states. It is anticipated that the EIC will be assigned from the MME’s home state.

Technology-Based Examination Process

In order to target companies to whom on-site examination teams will be sent, the states are relying on technology-driven solutions. Mortgage lenders subject to state examination will be required to upload to the state examiner’s automated compliance system information involving all of the mortgage loans originated over an examination period. This will enable the MMC to prescreen a licensee’s entire origination portfolio. By conducting a prescreening of key loan data, state regulators will be able to prioritize companies that need examination and target the on-site review of non-compliant mortgage loans. To that end, the MMC hired ComplianceEase® for its automated software to provide the technology for electronic examinations.

The trend, where permissible under state law, is to move away from set examination timetables toward more targeted examinations based on a company’s risk profile. Risk profiles may be based on, among other factors, the size of the company, its origination volume, the length of time since its last examination, complaint history, and/or net worth. States will monitor changes in the risk profile. For example, North Carolina recently announced that beginning January 1, 2011, it will require mortgage lenders and mortgage brokers to provide loan characteristics on their originations in an electronic format on a quarterly basis within 45 days after each calendar quarter.⁶ The state can use this

information to track loan origination violations and, in turn, recommend companies to the MMC.

While multi-state mortgage examinations are conducted by state regulators, their focus will encompass both federal and state consumer protection laws, with a bias towards federal compliance issues. The automated compliance systems will prescreen for compliance with federal laws (such as HMDA, TILA, HOEPA, RESPA) as well as state laws (including mini-HOEPA laws and other restrictions) and investor and government-sponsored entity requirements. Mortgage lenders and mortgage brokers should expect to be required to maintain in an electronic format, and download to regulators as requested, the following:

- information sufficient to enable a computation of key terms in the federal TILA disclosures, including the annual percentage rate, finance charges, and the payment schedule, and any deviations between initial and final disclosures;
- information included in the GFE disclosure required under RESPA including the rate, the date of any interest rate lock, itemization of amount financed, and all broker compensation;
- information included in the final HUD-1 Settlement Statement;
- information related to the terms of the loans, including adjustable rate loan features;
- information used in underwriting, including the value of the property (sales price and appraised), borrower's income, debt-to-income ratio, and credit score(s) of borrowers; and
- information included in a Loan Application Register for mortgage lenders required to submit information pursuant to HMDA.

Materiality will be a key component of the prescreening. The ComplianceEase® software assigns risk indicators to the different types of violations. These risk indicators will be considered by the MMC in determining the scope of the on-site examination.

The prescreening through automated compliance testing is the filter used to help determine if the

company will be a target for a multi-state mortgage examination and the depth and scope of a potential multi-state examination (i.e. whether that review will be off-site and/ or on-site, and the number of files reviewed). The MMC will also use detailed Information Requests⁷ (similar to the Manager's Questionnaire's that are being used more frequently by state examiners in preparation for an on-site examination) that will address issues such as depth of management, adequacy of policies and procedures, processes to identify and prevent mortgage fraud, underwriting procedures (including determination of ability to repay), and communication with borrowers.

Multi-State Mortgage Examinations Mean Higher Stakes

A traditional state examination typically is managed by a limited number of examiners who review a select number of loans from performing a random or adverse sample and apply a set of state requirements to those loans. The multi-state approach is much more intensive. A company may be examined by as many as eight to ten examiners from as many different jurisdictions. Those examiners will be conducting a 100% loan file review for compliance with multiple state and federal laws. Safety and soundness issues may be addressed as well. In addition to numerous off-site requests for information, a targeted on-site examination also may be conducted.

There is no doubt that a multi-state examination will be intrusive and monopolize a company's staff resources. Significant deficiencies may trigger reporting obligations to other state regulators under the NMLSR, lead to severe penalties, and put a company's reputation at risk.

With deficiencies and consequences suddenly magnified what should state licensed lenders do now?

Quality controls and internal controls are a must. Lenders must self-monitor for compliance and self-correct for violations. Lenders should audit themselves first by running the same tests as the examiners. If not required by state law (although some states do require this) consider subscribing to an automated compliance system compatible with the one utilized by the MMC. In their February 10,

2010 Media Release, CSBS and AARMR announced the availability of a new data file format called the Licensee Examination File that provides a standard method for approved systems to feed data directly to the regulators in a form that is readable by ComplianceEase®'s proprietary program.⁸

After re-running the same tests that the examiners will be conducting, self-correction is an imperative. The support of top management is a must. Self-correction alone, however, is not enough. Companies must review and modify their policies and procedures to ensure compliance with applicable law. Additionally, in reviewing internal policies and procedures, companies should terminate errant employees, stop doing business with questionable third parties and vendors, and document corrective actions.

¹ See Feb. 10, 2010 [State Mortgage Regulators Announce Launch of Standardized Loan Portfolio Data Format](#).

² Under the 2009 Agreement, states are required to sign on as either a "Joint Examination State Regulator" or a "Concurrent Examination State Regulator." A Joint Examination State Regulator may request from another state regulator supervisory information including confidential supervisory information. A Concurrent Examination State Regulator will receive non-confidential information.

³ A MME is any multi-state non-depository mortgage business with operations in two or more states. However, at the discretion of the MMC, a MME may include multi-jurisdictional entities under the supervision of more than one regulatory body, i.e. a state regulatory body and HUD/VA/FTC or other agency with supervisory authority or law enforcement authority over a MME.

⁴ Other states on the current committee include Arizona, Iowa, Kansas, Louisiana, Mississippi, New York, North Carolina, Pennsylvania and Wyoming. Representatives are from the banking departments in those jurisdictions.

⁵ Although not currently available, it is anticipated that it will become public. It is expected to incorporate model examination guidelines from the 2006 Nontraditional Product Risk Guidance, the 2007 Subprime Mortgage Lending Statement, and the 2008 Reverse Mortgage Examination Guidelines.

⁶ See 04 NCAC 03M.0401.

⁷ Information requests are available on the CSBS website: http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/MMCEExamTool_ExamReq.htm.

Conclusion

In the wake of the subprime market meltdown, federal regulators, and now state regulators, have placed a heavy emphasis on risk management. By using new technologies, uniting to measure compliance and sharing results, state regulators are sending a clear message to lenders: the stakes have been raised; penalties increased; and reputational risk magnified. Before the race for multi-state examinations begin, you would be wise to do a self-examination and take corrective action before you receive a visit from the Multi-State Mortgage Committee. We can help. If you are interested in K&L Gates conducting a comprehensive due diligence review, please give us a call.

⁸ See Feb. 10, 2010 Media Release from CSBS and AARMR, [State Mortgage Regulators Announce Launch of Standardized Loan Portfolio Data Format](#), providing that "[d]ocumentation on the new format will be available through the website www.RCCertify.org, which will launch on February 22, 2010."

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