“Me Too” Regulation: States Adopt Federal Guidance on Nontraditional Products

Fast on the tails of the federal banking agencies, state mortgage regulators are racing to adopt guidance on nontraditional mortgage product risks. The adoption of the guidance by those states raises a number of issues. Did the state agency have the authority to adopt the guidance? Did the state agency follow its state’s Administrative Procedure Act requirements? Is the guidance binding and mandatory, or is it simply a statement of policy? If it is not mandatory, how might the state agencies enforce or administer the guidance?

While the resolution of these issues remains to be seen, we attempt in this Client Alert to provide potential frameworks for analysis.

Issuance of the Guidance

In mid-November 2006, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) distributed guidance to state agencies that regulate residential “mortgage brokers and mortgage companies” on managing the risks posed by nontraditional mortgage products. CSBS and AARMR encouraged those state agencies to adopt their guidance and issue it for use by their regulated entities. In as little as two weeks, 15 states nearly tripped over each other to do so, feverishly issuing press releases announcing their adoption (or proposed adoption) of the guidance. At least eight more states quickly followed suit. What that means for their regulated mortgage entities remains to be seen, however.

Goal: Uniform Nontraditional Mortgage Guidance for All Mortgage Providers

The CSBS/AARMR guidance is based on the final interagency guidance released by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration on September 29, 2006. Late last year, we wrote two Client Alerts addressing the federal interagency guidance. As we described in those Alerts, the federal guidance applies generally to depository institutions and their subsidiaries, but does not apply to nondepository loan originators. CSBS and AARMR developed substantially parallel guidance (deleting sections inapplicable to nondepository institutions, such as portfolio performance and compliance with federal lending standards for safety and soundness). They say they did so to “promote consistent regulation of the mortgage market” and to clarify how other mortgage providers should disclose the risks of nontraditional mortgage products. CSBS and AARMR are encouraging all states to adopt the guidance so that “all consumers will be equally protected and all originators of residential mortgages will be subject to similar supervisory guidance.”

Many state mortgage lending regulatory agencies jumped at the invitation. Almost simultaneously with the CSBS/AARMR announcement, at least nine states reported that they were adopting or intending to adopt the guidance, and shortly thereafter at least 14 other jurisdictions followed with similar announcements. So far, just two months
after the CSBS/AARMR issued its guidance, we are aware of the following jurisdictions that have adopted or announced their intention to adopt the guidance or some version of the guidance: Connecticut, the District of Columbia, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, New Hampshire, North Carolina, North Dakota, Ohio, South Dakota, Texas, Vermont, Washington, and Wyoming. This list will almost certainly grow.

The federal agency guidance, and the parallel CSBS/AARMR guidance, do not prohibit lenders from making nontraditional mortgage products (i.e., products that “allow borrowers to defer payment of principal and, sometimes, interest,” particularly including interest-only mortgage loans and payment option ARMs). However, they “strongly caution” lenders to use stringent underwriting standards, and detail what those standards “should” include. The guidance also provides normative instructions for loan terms that lenders are encouraged to avoid and risk management practices that lenders are encouraged to adopt. Finally, the guidance urges lenders to apprise consumers of the benefits and risks of nontraditional mortgage products in a balanced and timely manner.

States Use Various Procedures in Adopting Guidance

The state agencies have taken various approaches to “adopting” the nontraditional mortgage product guidance. Agencies in Massachusetts, North Carolina, and Ohio have taken a formal approach, issuing the guidance in the form of a proposal, or incorporating the guidance by reference, and requesting public comment. (Massachusetts has since issued a final bulletin effective January 8, 2007; the agency did not make any changes to the bulletin as proposed, in spite of the numerous comments it received.) Mississippi also announced that it intends to issue the main points of the guidance as formal regulations, and Indiana is ambiguously “welcoming comments,” with no specified deadline or identified process for responding to comments. Other state agencies have taken actions such as issuing a regulatory bulletin (Vermont) or an administrative order (New Hampshire).

However, in nearly all the other states (including Connecticut, the District of Columbia, Idaho, Iowa, Kentucky, Minnesota, Montana, North Dakota, South Dakota, Vermont, Washington, and Wyoming), the regulatory agency simply issued a press release announcing that it has adopted the guidance and uniformly stating that the “guidelines are designed to level the playing field in the mortgage market in order to protect consumers from taking on high risk mortgages without having a full understanding of the terms of such loans.” In Georgia, Hawaii, Michigan, and Texas, the agencies appear to be touting the guidance as a set of “best practices.” In a unique move, Michigan’s Office of Financial and Insurance Services announced, in its Fourth Quarter 2006 newsletter, that it will begin collecting information on the calendar year 2007 sales of nontraditional mortgage products secured by dwelling property located in Michigan on the mortgage annual reports beginning with those due on or about February 28, 2008. The newsletter, which was certainly not subjected to any public notice or participation, orders licensees and registrants to adjust their recordkeeping systems to track those sales during 2007.

Can States Enforce the Principles in the Guidance?

In all those states, however, the “adoption” of the CSBS/AARMR state agency guidance raises similar questions for the regulated entities to which they are intended to apply. The primary questions go to the upshot—is the guidance binding and mandatory, or is it simply a statement of policy? If it is simply a statement of policy, will examiners use the guidance as a road map for analyzing lenders’ practices and portfolios, and what happens if an examiner finds variances from the guidance? Will the state agency or private plaintiffs’ counsel attempt to assert that a practice that arguably is inconsistent with the guidance is an unfair and deceptive practice, triggering a right to damages? These are all open questions for which there is no certain answer.

Virtually every state has enacted or adopted some version of the Model Administrative Procedure Act or its own version of such an act (“APA”). Under the APAs and traditional administrative law principles, an agency may issue rules or regulations only to the extent the legislature has granted the agency the authority to do so. Also, to implement or interpret a law that a state agency is authorized to administer or enforce, the agency must provide a notice-and-comment rulemaking process that conforms to the
state’s APA. Only then does the interpretation rise to the level of a rule or regulation that has the force and effect of law. Typically, mortgage regulators have authority to suspend or revoke a license, issue a cease and desist order, or impose a penalty (generally after notice and a hearing), based upon a violation of a duly promulgated rule or regulation. Perhaps that explains why certain state agencies have undertaken a public comment process—to comply with the state’s APA in an attempt to provide some “teeth” to the CSBS/AARMR guidance with regard to their licenses.

Still, it is unclear whether the agencies in those states have the authority to enforce or administer the guidance—or even adopt it in the first instance. The Massachusetts Division of Banks, for example, has the express authority to adopt rules and regulations “to aid in the administration and enforcement of” the Massachusetts Licensing of Mortgage Lenders and Brokers Act. While that Act addresses licensing requirements, it does not address loan underwriting or term restrictions. The Massachusetts anti-predatory lending provisions, on the other hand, do address certain underwriting restrictions, such as prohibiting the origination of high cost home loans without a reasonable belief the borrower will be able to make scheduled payments, based on his or her income, obligations, and employment. In fact, in accordance with express authority in the statute, the Massachusetts Division of Banks issued regulations implementing that provision. While the Division appears to have had authority to issue those regulations, it is less clear whether the Division has authority to issue the guidance that adds restrictions beyond those enacted by the legislature, even if the Division purports to do so through the APA. If the Division adds restrictions, rather than simply interpreting or implementing existing restrictions, then one may argue the Division has stepped beyond the authority the legislature conferred on it.

In comparison, the North Carolina Banking Commission announced it was adopting the CSBS/AARMR guidance but was “accepting public comment” on the guidance through January 2007. The North Carolina Mortgage Lending Act provides that “the Banking Commission may adopt any rules when it deems necessary to carry out the provisions of this [Act], to provide for the protection of the borrowing public, and to instruct mortgage lenders or brokers in interpreting this [Act].” As in Massachusetts, North Carolina’s high cost home loan provisions already address certain underwriting practices for those loans, such as requiring a reasonable belief regarding the borrower’s ability to repay, and establishing a presumption that a debt-to-income ratio of 50 percent or less is acceptable. However, no North Carolina agency has enacted any regulations to implement that restriction (and there appears to be no express authority for an agency to do so). Nonetheless, with the Commission’s issuance of the guidance and acceptance of public comment, we are left wondering whether it feels emboldened under the Mortgage Lending Act to promulgate any nature of guidance, no matter how vague or normative, with a claim that the guidance protects the borrowing public, and therefore is within the authority the legislature granted.

While several of the states that are attempting to adopt the nontraditional mortgage guidance have anti-predatory lending laws (similar to those of Massachusetts and North Carolina, mentioned above), several other states have not enacted statutes addressing underwriting practices. For example, Hawaii, Iowa, Montana, South Dakota, and Wyoming have not enacted an “ability to repay” provision, even for high cost home loans, and thus arguably have even less legislative authority than Massachusetts or North Carolina upon which to rely for issuing regulations on nontraditional mortgage loans.

If the authority of a state agency to issue regulations based on the nontraditional mortgage guidance is unclear, the enforceability of the guidance by state agencies is even less clear when they attempt to adopt the guidance without complying with their APA process. Typically, agency interpretive rules or statements of policy that have not been vetted through the APA process are not binding (although it is possible a hearing official or a court might nevertheless give them some weight). In fact, the APA statutes of some states expressly provide that an agency statement is not valid or effective against the public and is unenforceable unless the agency has observed proper APA rulemaking procedures. In all cases, however, it is hard to predict how an agency will attempt to enforce a set of standards based on sometimes overlapping “strong cautions” and “shoulds,” rather than on clear and specific directives. Some have speculated that unfair and deceptive practice statutes are one possible way in which an agency—or private plaintiffs’ counsel—might attempt
to enforce standards that offer no absolute directive or prohibition. Such claims often trigger rights to damages. This issue also remains to be seen.

**CSBS/AARMR Guidance Raises Many Other Questions**

Another interesting issue is to whom the guidance applies in a given state. The CSBS/AARMR guidance uses the term “providers.” State regulatory agencies and departments generally oversee hundreds of mortgage bankers, plus thousands of brokers or loan originators. However, while the guidance addresses consumer disclosure standards, it is generally drafted to apply to entities that conduct loan underwriting and make credit decisions. How exactly do the state agencies expect regulated brokers and loan originators to comply with the guidance when they typically do not participate in the underwriting or ultimate decision making process? Similarly, while the CSBS/AARMR guidance expressly mentions “mortgage brokers and mortgage companies,” it is not clear whether and how the agencies are going to apply the guidance to mortgage servicers or purchasers that are subject to licensing and regulation by many of these state agencies (including, for example, Georgia, Hawaii, Iowa, Kentucky, and New Hampshire). Thus, the states appear to be adopting the CSBS/AARMR guidance without any meaningful analysis of its applicability to or impact on the entities they regulate, or their authority to regulate the entities to which they may seek to apply the guidance.

Additional questions go to the details—to what specific types of loans does the guidance apply? Does it apply to all adjustable rate mortgage loans (“ARMs”), to all loans with a potential for “payment shock,” or to just those loans that allow the borrower to defer the payment of interest? What about typical ARM loans such as 2/28s, or even relatively standard 7/1 or 5/1 loans? Again, generally speaking, there are no answers, only questions.

**Nowhere to Hide from Nontraditional Mortgage Guidance**

In spite of one consumer advocate’s assertion that mortgage professionals will pay little attention to the CSBS/AARMR nontraditional mortgage guidance, state agencies across the country continue to adopt the guidance at a fast and furious pace. It appears that soon there will be no escape from their impact—albeit an impact that is uncertain. Even the Office of Federal Housing Enterprises Oversight, the HUD agency with the authority to oversee the safety and soundness of Fannie Mae and Freddie Mac, has directed those entities to follow the federal nontraditional mortgage guidance for their purchases of those loans. However, it remains to be seen whether the states will provide clear mandates to facilitate compliance with sound lending and consumer protection principles, or whether the process will be de facto driven by spooked investors.

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**Endnotes**


2. Specifically, the federal guidance applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

3. Ohio’s Attorney General regulations provide that “for nontraditional mortgage loan products and mortgage loan products with a discounted introductory rate, great weight and due consideration shall be given to the federal Interagency Guidance on Nontraditional Mortgage Product Risks . . . in deciding whether or not the [loan officer, mortgage broker, or nonbank mortgage lender] used a reasonable method of determining whether there was a reasonable probability of payment of the obligation by the consumer.” Ohio Admin. Code § 109:4-3-27 (eff. Jan. 7, 2007) (emphasis added).

4. See Florida State University’s Administrative Procedures Database at [http://www.law.fsu.edu/library/admin/admin3.html](http://www.law.fsu.edu/library/admin/admin3.html) for a table of state APAs.
We note, nonetheless, that the Division has issued bulletins and industry letters in the past addressing substantive restrictions on those lenders and brokers. See Steven L. Antonakes, Commissioner of Banks, “Industry Letter Regarding Reduced Documentation Mortgage Loans (Sept. 8, 2006) (purportedly applicable to mortgage lenders and brokers, as well as state-chartered financial institutions).

Thus, it appears the North Carolina Banking Commission may be attempting to comply with its APA.

It is unclear whether the statutory rulemaking authority requires a determination that all three factors are present ((i) carrying out the provisions of the Act, (ii) providing for the protection of the borrowing public, and (iii) instructing mortgage lenders or brokers in interpreting the Act) in order to justify rulemaking, or whether the agency may simply claim a broad mandate to “protect[] the borrowing public.”

However, other states, such as Idaho, Massachusetts, Montana, and Ohio, do not license entities that only purchase or service mortgage loans.

In December 2006, Senate Banking Committee Chairman Christopher Dodd, D-Conn., and five other senators wrote to the federal agencies, stating that the federal guidance on nontraditional loan products should cover 2/28 loans. However, we understand there has been an outcry from industry groups, which threaten that applying the nontraditional mortgage guidance to 2/28 loans could seriously disrupt the mortgage markets. Federal banking regulators reportedly intend to propose new interagency guidance on subprime 2/28 adjustable-rate mortgages.

Adam Rust, a research director at the Community Reinvestment Association of North Carolina, a Durham advocacy group, was quoted as saying “I don’t think mortgage ... [professionals] will pay much attention to this at all. . . . Especially at the broker level, they’re more concerned with volume . . . .” Frank Norton, “Limits Urged for Riskier Loans,” The News & Observer (North Carolina), Dec. 5, 2006.

Fannie Mae announced on December 20, 2006 that for mortgage loans with an interest-only feature that are underwritten outside of Desktop Underwriter, borrowers must be qualified using the principal, interest, taxes, and insurance payment (PITI) assuming a fully-amortizing repayment schedule based on either the applicable interest rate for a fixed rate mortgage or the fully-indexed rate for an ARM, and based on the mortgage’s term. See Fannie Mae Ann. 06-26, Expansion of Interest-Only Mortgage Loans Eligible for Delivery to Fannie Mae, and Elimination of the InterestFirst™ Product Name (Dec. 20, 2006). Those underwriting standards are included in the CSBS/AARMR guidance, which indicates that lenders “should” use them for nontraditional mortgage loans.
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