

WBSK MORTGAGE FINANCE NEWSLETTER

A PUBLICATION OF WEINER BRODSKY SIDMAN KIDER PC

California Court Rules Underwriting Fee Mark-ups May Violate Unfair Competition Law

A California appellate court has ruled that lenders that allegedly marked-up underwriting fees, wire transfer fees and tax service fees could be liable under California's Unfair Competition Law ("UCL").

In *McKell v. Washington Mutual, Inc.*, the California Court of Appeal found that allegations that lenders had marked up other settlement service providers' fees was sufficient to state a UCL claim. In so holding, the court adopted the Second Circuit's reading that a single settlement service provider may violate

RESPA by marking up the costs for work done by another settlement service provider. The appellate court overturned the demurrer that had been granted in favor of the lender and returned the case to the trial court

The borrowers in *McKell* alleged that the lenders charged them more for underwriting, tax services and wire transfer fees than the lenders had actually paid for those services. For example, whereas Fannie Mae and Freddie Mac charge only \$20 to underwrite a loan, the plaintiffs in this action claim that they were charged \$250 or \$400, and that

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President Signs Bill Limiting Interest Rates For Servicemembers

On October 16, 2006, President Bush signed the John Warner National Defense Authorization Act for Fiscal Year 2007 (the "Act"). The Act, which is effective on October 1, 2007, limits the annual percentage rate that may be paid by a covered member of the armed forces and a dependent of such a member in connection with a "consumer credit" transaction. Importantly, the definition of consumer credit transaction expressly excludes residential

mortgage loans, as well as purchase money loans secured by automobiles or personal property.

Unlike the federal Servicemembers Civil Relief Act ("SCRA"), which limits the amount of interest on debts incurred by a servicemember prior to entering active military service, the limitations found in the Act apply to consumer credit transactions entered into by a covered member while on active duty. Another important difference between the Act and the SCRA is that the limitations found in the Act apply when a dependent enters into a consumer credit transaction regardless of whether a covered member also becomes obligated on the debt.

The SCRA, on the other hand, applies only to extensions of credit made jointly to a servicemember and a dependent of the servicemember.

The term covered member of the armed forces applies to a member of the armed forces who is on active duty or active Guard and Reserve Duty. With respect to a covered member, the term dependent means the spouse of a member, the child of a member or an individual for whom the member provided more than one-half of that individual's support for the 180 days immediately preceding the extension of credit.

The Act prohibits creditors from imposing an annual percentage rate



greater than 36 percent with respect to the consumer credit extended to a covered member or a dependent of a covered member, regardless of whether the credit agreement, note or applicable law permit a greater rate. Creditors will be required to provide to the member or the dependent the following information orally and in writing before the extension of consumer credit (including any such credit originated or extended through the internet): (i) a statement of the annual percentage rate applicable to the extension of credit; (ii) any disclosures required under the federal Truth-in-Lending Act; and (iii) a clear description of the payment obligations of the member or dependent, as applicable. Such disclosures must be presented in accordance with Regulation Z.

The Act preempts any state or federal laws, rules or regulations (including any state usury law) to the extent that such laws, rules or regulations are inconsistent with the Act. However, the Act does not preempt any such laws, rules or regulations that provide protection to a covered member or a dependent of such a member in addition to the protection provide by the Act. ■

Indiana Bank Settles With Justice Department Regarding Alleged Discrimination

On October 13, 2006, the United States Department of Justice (“DOJ”) settled a discrimination complaint with Centier Bank of Whiting, Indiana (“Centier”). In its complaint, the DOJ alleged a pattern of discriminatory behavior. The DOJ alleged that Centier violated the Fair Housing Act (“FHA”) by discriminating on the basis of race, color, and national origin when making residential

real estate-related transactions, making dwellings unavailable, and in the terms, conditions or privileges in the provision of residential sale services. The DOJ also alleged that Centier violated the Equal Credit Opportunity Act (“ECOA”) by discriminating on the basis of race, color and national origin with respect to credit transactions.

The DOJ alleged that Centier’s policies and practices constituted a pattern of resistance to the rights provided by the FHA and ECOA, and pointed to a number of facts supporting their position. The DOJ alleged that from 2000-2004, Centier generated 9,031 single-family residential loan applications in the Gary, Indiana metropolitan area. Of those, only 437 (4.8%) were secured by real property located in a minority-majority census tract. During the same five years, Centier generated 7,360 single-family residential loans, of which only 248 (3.4%) were secured by residential property located in minority-majority census tracts. The total value of the funded loans was \$740 million, but only \$12.3 million (1.65%) went to minority-majority census tracts. The DOJ claimed that Centier’s policies and practices were intentional, willful, and implemented with intentional disregard for the rights of residents of minority neighborhoods.

In its settlement with the DOJ, Centier responded that its lending complied with both the letter and spirit of the fair lending laws, and was nondiscriminatory. Centier stated that until restrictions eased in the 1980’s, Indiana law prohibited it from branching into cities where home offices of other banking institutions resided. Centier then pointed to the “rust belt recession” in the 1980’s, which has continued until the present day. Finally, Centier acknowledged that its lending percentages for loans in minority-majority census tracts was lower than their competition, but that this was due to external circumstances rather than a general

discriminatory lending policy.

Subsequent to investigation initiation, Centier began ameliorating its previous policies and practices. Examples of these actions include hiring two new minority executives, collaboration with a non-profit to originate loans in low to moderate income areas, and offering a reduced interest rate on home improvement loans in Gary, Indiana. The settlement itself, in which the DOJ agreed to withdraw its complaint, contains a number of additional remedial acts. First, Centier must ensure that all types of credit are made available and marketed in majority minority census tracts. Second, Centier must expand its supermarket branch in East Chicago, Indiana to include two private offices and a conference room, to place at least one full-time residential lender in the office, and provide at least one employee at the branch who is fluent in Spanish. Third, Centier must acquire at least two full-service branch offices in the designated minority majority areas, and they must be comparable to the branches located in predominantly white tracts. Fourth, Centier must employ a full-time Director of Community Lending, who will oversee Centier’s development of lending in minority-majority census tracts. Fifth, Centier must train employees with significant involvement in residential and Community Reinvestment Act (“CRA”) small business lending to ensure that their activities are conducted in a nondiscriminatory manner. Sixth, Centier must expand its marketing, advertising and outreach programs. Seventh, Centier must assess the credit needs of the residential real estate-related and small business credit needs of the minority-majority census tracts. Finally, Centier agreed to invest at least \$3.5 million over the course of five years in a special financing program for residential and CRA small business loans. These special loans include rate discounts for home loan purchases, down payment assistance and closing cost assistance. ■

the defendant lenders failed to disclose to them that (1) they were performing no underwriting services and (2) they were charging the borrowers fees for that service that exceeded their costs and were retaining the extra amount charged.

The plaintiffs claimed that the lenders' practices "deceive[] consumers by leading them to reasonably conclude that the amount listed [on the HUD-1] is the amount incurred," and that deception is a violation of the UCL prohibitions against (1) fraudulent business practices; (2) unfair business practices; and (3) unlawful business practices. The plaintiffs based their unlawful business practice claim on the lender defendants' alleged violations of, inter alia, RESPA, Regulation X, and HUD's policy statements.

The trial court had dismissed their claims finding that there was no requirement that the lenders charge only pass through amounts. The appellate court disagreed, holding that the plaintiffs had stated a claim under the UCL based on (1) fraudulent business practices; (2) unfair business practices; and (3) unlawful business practices. As to fraudulent business practices, the Court of Appeal held that whether the practice was "fraudulent" under the UCL could not be "mechanistically determined" on a demurrer and that the plaintiffs' allegations of fraud were sufficient to state a claim notwithstanding the fact that "federal law only requires that the HUD-1 itemize the charges imposed on the buyer and seller," rather than the cost to the lender.

Regarding the UCL claim based on unfair business practices, the Court of Appeal held that the plaintiffs "alleged a violation of the federal public policy of expanding opportunities for home ownership by reducing the cost of borrowing, in part through the use of automated underwriting software." In response to the defendant lenders' argument that the doctrine of judicial abstention should prevent the court from involving itself in setting prices for lending services, the Court of Appeal held that by addressing the plaintiffs' UCL claims, it was only "enforcing already-established economic policies," rather than entering an arena requiring a legislative determination of the propriety of the defendant lenders' actions.

The plaintiffs base their third category of UCL claims – those asserting an unlawful business practice – on viola-

tions of, inter alia, RESPA, Regulation X, HUD regulations and policy statements interpreting RESPA. In addressing whether the defendant lenders' alleged practice of "charging more than pass-through costs" violates RESPA, the Court of Appeal examined the language of section 8(b), which provides that "[n]o person shall give and no person shall accept any . . . charge made or received . . . other than for services actually performed." The Court examined the split in the federal circuit courts regarding whether the "and" language of section 8(b) is to be read as requiring the involvement of both a giver and acceptor of a fee other than for services actually performed to constitute a violation or, instead, if a single person may violate section 8(b) by either giving or accepting such a fee. Noting that it was not bound by any federal circuit precedent, the Court of Appeal rejected the position of the Fourth, Seventh, and Eighth Circuit that a giver and a receiver of the charge is required for a section 8(b) violation and, instead, adopted the reasoning of the Second Circuit in *Kruse v. Wells Fargo Home Mortgage, Inc.* regarding alleged mark-ups. The Court of Appeal found persuasive the *Kruse* court's analysis that section 8(b) does not clearly and unambiguously state that an alleged mark-up requires both a giver and receiver and, therefore, it was appropriate to look at HUD's interpretation of section 8(b) as evidence of legislative intent. Because HUD has interpreted the provision as not requiring a split of an alleged fee mark-up, and because this interpretation "is consistent with Congress's stated intent to protect consumers from unnecessarily high settlement charges," the Court of Appeal held that the plaintiffs had stated a claim for unlawful business practices under the UCL.

Moreover, the Court of Appeal found that the plaintiffs' UCL claim was not preempted by the Home Owners' Loan Act ("HOLA"). Specifically, the Court held that where the UCL is invoked for the purpose of "enforce[ing] federal law governing the operation of federal savings associations" – rather than "to enforce a state law purporting to regulate the lending activities of a federal savings association" – there was no preemption. Further, the Court held that allowing borrowers to sue under the UCL for unlawful disclosures would not interfere with applicable federal law, and – although not raised by the defendant lenders – stated that RESPA does not preempt the UCL.

California Enacts Legislation Regarding Automated Valuation Models

Effective January 1, 2007, a licensed California Finance Lender ("CFL") may collect a fee from a borrower of up to the actual cost paid to a third party for a written automated valuation model report ("AVM report"). The CFL may not charge a borrower for both an AVM report and an appraisal for the same property in a single transaction. If the borrower obtains a new or additional loan and has paid a fee for an AVM report within one year for the same real property, the CFL may charge an appraisal fee minus the amount paid by the borrower for the AVM report. If the borrower has obtained a new or additional loan for the same real property and more than one year has elapsed since the prior delivery of an AVM report or an appraisal, a CFL may collect fees for another AVM report or appraisal.

A CFL must provide notice to a borrower, within 15 days after receiving a written application, of the borrower's right to receive a copy of the AVM report if he or she paid a fee for the report and the borrower sends a written request for a copy of the report and the request is received by the CFL no later than 90 days after (1) the CFL provided notice of the action taken on the application (including notice of incompleteness), or (2) the borrower withdraws the application. The CFL must then mail or deliver a copy of the AVM report within 15 days after receiving the request from the borrower, or within 15 days after receiving the report, whichever occurs later.

The notice of the borrower's right to a copy of the AVM report must be in at least 10-point boldface type, as a separate document. The notice must specify that the borrower's request must be in writing and must be received by the CFL no later than 90 days after the CFL provides notice of the action taken on the application, or within 90 days after withdrawal of an application. The notice must also include the following statement: "An automated valuation model is not an appraisal. It is a computerized property valuation system that is used to derive a real property value." Lastly, the notice must include an address to which the request should be sent. The CFL may condition release of the AVM report to the borrower upon payment of the fee.

Montana Updates Record Keeping Requirements for Licensed Mortgage Brokers

Effective September 8, 2006, the Montana Division of Banking and Financial Institutions implemented a regulation that details new record keeping obligations for licensees. The regulation sets forth each of the items that must be included in a Mortgage Broker Licensee's loan files and trust accounts. The new regulation also requires that a Mortgage Broker Licensee reconcile its trust accounts on a monthly basis.

Agencies Issue Final Guidance On Nontraditional Mortgages

The Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve ("Board"), Federal Deposit Insurance Corporation ("FDIC"), Office of Thrift Supervision ("OTS"), and National Credit Union Administration ("NCUA") (collectively, "Agencies") issued final guidance on nontraditional mortgage product risks (the "Guidance"). The Guidance is substantially similar to the proposed guidance issued on December 29, 2005. For an overview of the proposed guidance, please see the February 2006 edition of our newsletter. For purposes of this article, the comments and changes to the proposed guidance will be discussed.

The Agencies clarified the meaning of "nontraditional mortgage products" as all products that allow borrowers to defer repayment of principal or interest, including all interest-only products and negative amortization mortgages. Interest-only loans with extended interest-only periods specifically fall within the auspices of the Guidance. Home equity lines of credit ("HELOCs"), with the exception of HELOCs as simultaneous second-lien loans, and reverse mortgages are excluded.

Many diverse parties commented on the proposed guidance's consumer protection provisions. Financial and trade group commenters suggested that consumer protection goals could be better effectuated through the Truth in Lending or Real Estate Settlement Procedures Acts. Other commenters felt that the lenders are not in a position to decide

which products are best for borrowers, and that the decision should be left to the borrowers themselves. Consumer groups and community organizations questioned whether additional measures, such as consumer education and counseling and additional disclosures should be required.

The Agencies determined that the guidelines are needed because of explosive growth in the nontraditional mortgage product industry. They responded to concerns that disclosures will be lengthy by providing examples based on hypothetical loan transactions. Moreover, the Agencies have provided a sample pamphlet entitled, "Interest-Only Mortgage Payments and Payment-Option ARMs – Are They For You?"

Many commenters felt that the Agencies' guidance on qualifying buyers was too restrictive. The Agencies responded that, "institutions should maintain qualification standards that include a credible analysis of a borrower's capacity to repay the full amount of credit that may be extended." They declined to make any modification to the proposed guidance for qualifying borrowers, and expect a negative amortization borrower to demonstrate the capacity to repay the full loan amount that may be advanced.

The Agencies also clarified language with respect to collateral-dependent loans and risk layering. For collateral-dependent loans, the Guidance provides that a loan is not collateral-dependent solely because it was underwritten using reduced documentation. For risk layering, reduced documentation and second-lien loans are not prohibited, but the Guidance requires strong quality control and risk mitigation. Reduced documentation loans are not limited to a particular set of circumstances, but the Agencies cautioned institutions to

generally be able to readily document income for wage earners.

With respect to portfolio and risk management practices, the Guidance emphasizes that institutions should exercise appropriate due diligence before entering into a third-party relationship and provide ongoing, effective oversight and controls. The Guidance reiterates existing guidelines regarding implicit recourse for loans sold in the secondary market, and does not establish new capital requirements.

The proposed guidance listed suggested monitoring tools, such as call monitoring and mystery shopping as a means of monitoring quality control. The final Guidance for institutional control systems, however, was revised to clarify that no particular means of monitoring is required. Additionally, institutions will not be expected to assume an unwarranted

level of responsibility for the actions of third parties, but the required control systems for loans purchased from or originated through third parties must be consistent with current supervisory policies.

In their overview of the public comments, the Agencies noted that many commenters were concerned that the final guidance would only apply to federally regulated financial institutions. The Agencies, however, noted that both the Conference of State Bank Supervisors ("CSBS") and the State Financial Regulators Roundtable ("SFRR") commented on the proposed guidance, and are committed to working with state agencies to create guidance that is similar in scope and nature to non-federally regulated financial institutions. Moreover, the CSBS and the American Association of Residential Mortgage Regulators ("AARMR") issued a press release to the same effect earlier this summer. ■



HUD Clarifies Rules on Part-time Employment

On October 5, 2006, the HUD Atlanta Homeownership Center (HOC) issued an informal letter clarifying certain provisions of HUD's new Mortgagee Approval Handbook, 4060.1, REV. 2, concerning part-time employment restrictions for loan officers. In its letter, the Atlanta HOC noted that pursuant to HUD Handbook 4060.1 REV-2, Paragraph 2-9, a mortgagee may employ staff on a full time or part time (less than the 40 hour work week) basis. Part-time employees may have other employment, including self-employment. Such outside employment may not, however, be in the mortgage lending, real estate, or a related field. Direct endorsement underwriters are included in this provision.

Thus, according to the latest provisions in HUD's Mortgagee Approval Handbook, 4060.1, REV. 2, issued and effective on August 14, 2006, and as clarified by the Atlanta HOC letter, an individual acting as a FHA loan originator cannot act as an active real estate broker and originate FHA loans. However, loan officers of a FHA approved lender involved in other types of financing may concurrently originate loans and act as active real estate brokers. ■

Enforcer of Security Interest May Be Debt "Collector"

In the recent decision of *Kaltenbach v. Richards*, the Fifth Circuit considered whether an attorney hired to enforce a security interest could be subject to the entire Fair Debt Collection Practices Act ("FDCPA") if the

attorney otherwise meets the general definition of a “debt collector” under §1692a(6) of the Act. The Court answered in the affirmative.

In *Kaltenbach*, plaintiff used his mobile home as security on a loan. When plaintiff repeatedly failed to satisfy his mortgage obligation, the creditor notified plaintiff that he was in default; that the loan balance had been accelerated; and that it might exercise its right to repossess the home. When plaintiff continued to miss payments, the creditor hired an attorney to initiate foreclosure. Following a sale of the home, plaintiff brought suit against the attorney, alleging that the attorney had violated §1692g of the FDCPA by failing to provide a “dunning letter” prior to the foreclosure.

The attorney moved to dismiss plaintiff’s complaint, contending that he was not a debt collector subject to §1692g’s notice requirements because he was merely enforcing a security interest – activity which is governed by § 1692f(6) of the statute, and which specifies when a debt collector may fairly take or threaten to take nonjudicial action to effect a dispossession. The district court agreed that plaintiff could not bring a claim under § 1692g and granted the motion to dismiss.

On appeal, the Fifth Circuit reversed and remanded. In so doing, the court first concluded that the FDCPA is ambiguous as to whether § 1692g applies if an entity that is merely enforcing a security interest also satisfies the general definition of “debt collector.” Deferring to the FTC’s interpretation that the entire FDCPA can apply to parties whose principal business is enforcing security interests and who also meet § 1692a(6)’s general definition of a debt collector, the Fifth Circuit held that a party who satisfies § 1692a(6)’s general definition of a “debt collector” is a debt collector for the purposes of the entire FDCPA, even when enforcing security interests.

While acknowledging that several courts have held that § 1692f(6) is the only section of the statute that regulates the enforcement of security interests, the Fifth Circuit disagreed with that view, opining that other sections of the FDCPA (i.e., § 1692i(a)(1)) also regulate the enforcement of security interests.

On remand, the district court was instructed to consider whether the plaintiff did in fact fit within the general definition of “debt collector.” ■

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South Carolina Supreme Court Rules Disbursement of Loan Proceeds Constitutes Practice of Law

On October 23, 2006, in *Doe Law Firm v. Richardson and McMaster*, the South Carolina Supreme Court ruled that the disbursement of loan proceeds in conjunction with a residential refinancing or credit line transaction constitutes the practice of law in that state. The Court held that the disbursement of loan funds is an integral step in the closing of a residential refinancing or credit line transaction, and that such disbursements must be conducted under the supervision of a licensed South Carolina attorney. The Court noted that since its decision constituted a new rule, and since it is likely that lenders and attorneys will need to establish new procedures that do not currently account for this step in the closing process, the effective date of the opinion is delayed until January 22, 2007.

WBSK MORTGAGE FINANCE NEWSLETTER

is a publication of the law firm of

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