

WBSK MORTGAGE FINANCE NEWSLETTER

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Banking Agencies Propose Guidance on Nontraditional Mortgage Products

The federal financial institution agencies (“Agencies”) recently issued proposed *Inter-agency Guidance on Nontraditional Mortgage Products* (“Guidance”). If adopted, the Guidance will apply to credit unions, banks and savings associations and their subsidiaries, and to bank and savings association holding companies and their subsidiaries. Although the Guidance will not apply to independent mortgage companies, it likely will affect the origination operations of many mortgage companies that broker or sell nontraditional mortgage loan products to such entities. Comments on the proposed Guidance are due on or before February 27, 2006.

NONTRADITIONAL MORTGAGE PRODUCTS.

The proposed Guidance does not define the term “nontraditional mortgage product.” Rather, the Agencies note the recent demand “for mortgage products that allow borrowers to defer payment of principal and, sometimes, interest” and state that these products are often referred to as “nontraditional mortgage products” and include “interest-only” mortgages and “payment option” adjustable rate mortgages. An

“interest-only mortgage loan” is defined in part as a “nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed.” A “payment option ARM” is defined as follows:

A nontraditional mortgage that allows the borrower to choose from a num-

ber of different payment options. For example, each month, the borrower may choose a minimum payment option based on a “start” or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on ei-

ther a 15-year or 30-year loan term plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly

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Seventh Circuit: Firm Offer of Credit Cases Suitable for Class Certification

The United States Circuit Court of Appeals for the Seventh Circuit recently has opined that claims alleging violation of the federal Fair Credit Reporting Act, 15 U.S.C. § 1681, *et seq.* (“FCRA”), in connection with the extension of “firm offers of credit” may be suitable for class treatment. In *Murray v. GMAC Mortgage Corporation*, the Seventh Circuit vacated the district court’s decision denying class

certification and, in doing so, rejected the lender’s argument that “firm offer of credit” cases pose individual questions that preclude class treatment.

The *Murray* decision comes a little more than a year after the same Court’s ruling in *Cole v. U.S. Capital, Inc.*, 389 F3d 719 (7th Cir. 2004). In *Cole* the Seventh Circuit considered the statutory definition of “firm offer of credit,” and whether the district court had properly applied that definition in dismissing plaintiff’s claim under the Act. In ruling that the lower court’s dismissal was improper, the Court rejected the prevailing wisdom that the proper focus for assessing a “firm offer of credit”

is limited to satisfying the two prongs of the statutory definition: (1) whether any offer of credit was made; and (2) whether the creditor intended to honor that offer. Instead, the Seventh Circuit offered its own definition of “firm offer of credit,” finding that the proper inquiry is whether the offer has adequate “value” to the consumer. According to the Court, “[t]he statutory scheme of the FCRA makes clear that a ‘firm offer’ must have sufficient value for the consumer to justify the absence of the statutory protection of his privacy.” The Seventh Circuit further explained, “a court must consider the *entire* offer and the effect of *all* the ma-

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payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

While the Agencies note that nontraditional mortgage products offer payment flexibility and are an effective and beneficial financial management tool for some borrowers, the proposed Guidance focuses on the risks associated with the products—both for financial institutions and for consumers. The proposed Guidance addresses “layering,” which is a term used by the Agencies to describe the combination of nontraditional mortgage products with practices such as simultaneous second lien loans and reduced documentation requirements. The Agencies believe that “layering practices can present unique risks that institutions must appropriately measure, monitor and control.” The Agencies also express concern that nontraditional mortgage products are being offered to a wider spectrum of borrowers who may not fully understand the associated risks.

The proposed Guidance focuses on (1) loan terms and underwriting standards, (2) portfolio and risk management practices and (3) consumer protection issues.

LOAN TERMS AND UNDERWRITING STANDARDS.

The Agencies first note that the underwriting standards of financial institutions must comply with the Agencies’ real estate lending standards and appraisal regulations and associated guidelines. The Agencies also strongly caution institutions “against ceding underwriting standards to third parties that have different business practices, risk tolerances, and core competencies.” The Agencies address the following: qualification standards, collateral-dependent loans, risk layering, reduced documentation, simultaneous second lien loans, introductory interest rates, lending to subprime borrowers and non owner-occupied investor loans.

Qualification Standards. An institution’s qualification standards should recognize the potential impact of significant increases in the monthly payments required under nontraditional mortgage products (which the Agencies refer to as “payment shock”), and that “nontraditional mortgage products often are inappropriate for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores.” Significantly, the analysis of a borrower’s repayment capacity should include an

evaluation of the borrower’s ability to repay the debt by the final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The “fully indexed rate” is the index rate prevailing at the time of origination, plus the margin that will apply, after the expiration of an introductory rate period. Because the fully indexed rate for an ARM loan that is based on a “lagging index,” such as the Moving Treasury Average (MTA), may be significantly different from the rate on a comparable 30-year fixed rate product, in such cases institutions should use a “credible market rate” to qualify the borrower and determine repayment capacity.

If the loan product provides for negative amortization, the repayment analysis should include the initial loan amount plus any balance increases that may accrue from negative amortization, based on the initial loan terms and the assumption that the borrower will make only the minimum payments during the deferral period. Consideration also should be given to potential risks that a borrower may face in refinancing the loan at the time it begins to fully amortize, such as prepayment fees.

The proposed Guidance cautions that the analysis of repayment “should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process.”

Collateral-Dependent Loans. Although not defined, the term “collateral-dependent loans” is used in the context of loans with terms or underwriting practices that may result in a borrower having to rely on the sale or refinance of the property once amortization begins. The Agencies caution that “[l]oans to borrowers who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Institutions determined to be originating collateral-dependent mortgage loans . . . may be subject to criticism, corrective action, and higher capital requirements.”

Risk Layering. The increased risk that the Agencies believe results from the combination of nontraditional mortgage loans with reduced documentation and/or simultaneous second lien loans should be compensated for with mitigating factors that support the underwriting decision and the borrower’s repayment capacity. Such factors “might include” higher credit scores, lower LTV and DTI ratios, credit enhancements and mortgage insurance. The proposed Guidance

notes that “[w]hile higher pricing may seem to address the increased risks associated with risk-layering features, it raises the importance of prudent qualification standards discussed [in the proposed Guidance].”

Reduced Documentation. “Reduced documentation” is defined as “[a] loan feature that is commonly referred to as ‘low doc/no doc,’ ‘no income/no asset,’ ‘stated income’ or ‘stated assets.’ For mortgage loans with this feature, an institution sets reduced or minimal documentation standards to substantiate the borrower’s income and assets.” As the level of credit risk increases, the Agencies expect that an institution will apply more comprehensive verification and documentation procedures to verify a borrower’s income and debt reduction capacity. Additionally, reduced documentation, such as stated income, should be accepted only if there are other mitigating factors, such as lower LTV and other more conservative underwriting standards.

Simultaneous Second Lien Loans. A “simultaneous second-lien loan” is defined as “[a] lending arrangement where either a closed-end second-lien or a home equity line of credit (HELOC) is originated simultaneously with the first lien mortgage loan, typically in lieu of a higher down payment.” The Agencies caution that simultaneous second-lien loans result in reduced owner equity and higher credit risk, and the borrowers with minimal or no equity in a property may have less incentive to work with a lender to bring the loan current and avoid foreclosure. Significantly, the proposed Guidance provides that “[l]oans with minimal owner equity should generally not have a payment structure that allows for delayed or negative amortization.”

Introductory Interest Rates. The Agencies caution that because initial monthly mortgage payments for nontraditional mortgage products are based on low introductory rates, there is a greater potential for a borrower to experience negative amortization, increased payment shock and earlier recasting of the monthly payments than originally scheduled. In setting introductory rates, institutions should consider ways to minimize the probability of disruptive early recastings and extraordinary payment shock.

Lending to Subprime Borrowers. Mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should follow the applicable guidelines of the Agencies on subprime lending. The Agencies note that such guidelines address when subprime lending can become predatory or abusive. The Agencies also note that the practice of

risk layering for loans to subprime borrowers may significantly increase the risk to both the institution and the borrower.

Non Owner-Occupied Investor Loans. Borrowers for non owner-occupied loans should be qualified on their ability to service the debt over the life of the loan, and loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Additionally, there should be evidence that the borrower has sufficient cash reserves to service the loan in the near term in the event that the property becomes vacant.

PORTFOLIO AND RISK MANAGEMENT PRACTICES.

The Agencies state institutions should recognize that nontraditional mortgage loans are untested in a stressed environment and, accordingly, should receive higher levels of monitoring and loss mitigation. Additionally, institutions are advised to ensure that portfolio and risk management practices keep pace with the growth and changing risk profile of their nontraditional mortgage portfolios. The Agencies caution that they will carefully scrutinize institutions' risk management processes, policies and procedures, and remedial action will be requested from institutions that do not adequately manage the risks.

The Agencies address the following specific risk elements: policies, concentrations, controls, third-party originations, secondary market activity, management information and reporting, stress testing, and capital and allowance for loan and lease losses.

Policies. An institution's policies for nontraditional mortgage lending activity should set forth acceptable levels of risk through its operating practices, accounting procedures and policy exception tolerances. Further, an institution should set growth and volume limits by loan type.

Concentrations. Concentration limits should be set for loan types, third party originations, geographic area, and property occupancy status to maintain portfolio diversification. Additionally, concentration limits also should be set on key portfolio characteristics, such as loans with high combined LTV and DTI ratios, loans with the potential for negative amortization, loans to borrowers with credit scores below established thresholds, and nontraditional mortgage loans with layered risks. Significantly, institutions are advised to consider the effect of employee incentive programs that may result in

higher concentrations of nontraditional mortgage loans.

Controls. An institution's quality control, compliance and audit procedures should specifically target those mortgage lending activities exhibiting higher risk and, for nontraditional mortgage loan products, an institution should have appropriate controls to monitor compliance with, and exceptions to, underwriting standards. When control systems or operating practices are found to be deficient, business line managers should be held accountable for correcting deficiencies in a timely manner. Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals and loan modifications are not inadvertently increasing risk.

Third Party Originations. Institutions that use third party channels to originate nontraditional mortgage loans should have strong approval and control systems to ensure the quality of the originations and compliance with all applicable laws and regulations, with particular emphasis on marketing and borrower disclosure practices. Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics in order to identify problems, such as early payment defaults, incomplete documentation and fraud. If appraisal, loan documentation or credit problems are discovered, the institution should take immediate action, which could include terminating its relationship with the third party.

Secondary Market Activity. Institutions with significant secondary market reliance should have comprehensive, formal approaches to risk management that should include consideration of the risks to the institution should demand in the secondary market dissipate. The Agencies note that, to protect its reputation, an institution may elect to repurchase defaulted mortgage loans even when it is not required to do so. The Agencies advise that they view the purchase of mortgage loans beyond the selling institution's contractual obligations as implicit recourse and, under their risk-based capital standards, the Agencies would require that risk-based capital be maintained against the entire portfolio or securitization.

Management Information and Reporting. Reporting systems should allow management to isolate key loan products, risk-layering features and borrower characteristics to allow early identification of performance deterioration. At a minimum, information should be available by loan type (e.g., interest-only mortgage loans

and payment option ARMs), the combination of these loans with risk-layering features (e.g., payment option ARMs with stated income and interest-only mortgage loans with simultaneous second-lien mortgages), underwriting characteristics (e.g., LTV, DTI and credit score) and borrower performance (e.g., payment patterns, delinquencies, interest accruals and negative amortization). Further, volume and performance expectations should be established at the subportfolio and aggregate portfolio levels, and variance analyses should be performed regularly to identify exceptions to policies and prescribed thresholds. A qualitative analysis should be performed when actual performance deviates from established policies and thresholds.

Stress Testing. Institutions should perform sensitivity analyses on key portfolio segments, and such analyses generally should include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations and other factors beyond the institution's immediate control. Stress tests typically assume rapid deterioration in one or more factors and attempt to estimate the potential influence on default rates and loss severity. Significantly, the stress testing should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits and capital levels.

Capital and Allowance for Loan and Lease Losses. Institutions should establish appropriate allowances for the estimated credit losses in their nontraditional mortgage loan portfolios and hold capital commensurate with the risk characteristics of these portfolios. As loan terms evolve and underwriting practices ease, the lack of seasoning for the loans may warrant higher capital levels. In establishing appropriate allowances and considering the adequacy of capital, institutions should segment their nontraditional mortgage loan portfolios into pools with similar credit risk characteristics. Institutions with material mortgage banking activities and mortgage servicing assets should apply sound practices in valuing the mortgage servicing rights of nontraditional mortgages in accordance with interagency guidance (and the Agencies refer to the February 2003 Interagency Advisory on Mortgage Banking).

CONSUMER PROTECTION ISSUES.

The Agencies state that nontraditional mortgage products have been advertised and promoted based on their near-term monthly payment affordability,

and consumers have been encouraged to select nontraditional mortgage products based on the lower monthly payments that such products permit compared with traditional types of mortgages. The Agencies advise that institutions should ensure that consumers are appropriately alerted to the risks of these products, including the likelihood of increased future payment obligations, and have information that is timely and sufficient for making a sound product selection decision. The Agencies address the following specific topics: concerns and objectives, legal risks and recommended practices.

Concerns and Objectives. Institutions should ensure that communications with consumers, including advertisements, oral statements, promotional materials and monthly statements, are consistent with product terms and payment structures. These communications should provide clear and balanced information about the relative benefits and risks of nontraditional mortgage products, including the risks of payment shock and negative amortization (which are the risks that appear to concern the Agencies the most).

Legal Risks. In noting that disclosures and other information provided to consumers regarding nontraditional mortgage products must comply with applicable law, the Agencies cite not only the federal Truth in Lending Act and federal Real Estate Settlement Procedures, but also Section 5 of the Federal Trade Commission Act. That Section prohibits unfair or deceptive practices. The Agencies also note that state laws, including laws regarding unfair or deceptive acts or practices, may be applicable. Clearly, the Agencies are indicating that compliance with technical disclosure and advertising requirements is not sufficient—disclosures and promotional materials also must not be unfair or deceptive with regard to their presentation of nontraditional mortgage products.

Recommended Practices. The Agencies recommend practices regarding communications with consumers and control systems to address risks raised by nontraditional mortgage products.

Communications with Consumers. Institutions should present information in a clear manner and format so that consumers will notice it, can understand it to be material, and will be able to use it in their decision-making processes. For example, institutions should offer full and fair product descriptions when a consumer is shopping for a mortgage, and not just upon the submission of an application or at consummation.

Promotional materials and descriptions

of nontraditional mortgage products should provide information that enables consumers to prudently consider the costs, terms, features and risks of the mortgages in their product selection decisions, including information about payment shock, negative amortization, prepayment fees and the cost of reduced documentation loans. With regard to payment shock, institutions should apprise consumers of potential increases in their payment obligations (e.g., in both dollar and percentage terms), including situations in which interest rates or negative amortization reach a contractual limit. For example, product descriptions should specifically state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example, once amortizing payments are required and the interest rate and negative amortization caps have been reached. With regard to negative amortization, institutions should apprise consumers of the potential consequences of increasing principal balances and decreasing home equity. For example, product descriptions should include, with sample payment schedules, corresponding examples showing the effect of the payments on the consumer's loan balance and home equity. If a product provides for a prepayment fee, the institution should alert the consumer to this fact, and to the amount of the fee. If an institution offers both reduced and full documentation loan programs, and there is a pricing premium attached to the reduced documentation program, the institution should alert the consumer to this fact.

Monthly statements for payment option ARMs should provide information that enables consumers to make responsible payment choices, including information about the current principal balance and the consequences of selecting various payment options. Institutions should avoid leading borrowers to select the minimum payment, for example, through the format or content of monthly statements. Institutions should avoid practices that obscure significant risks to the consumer, and avoid practices such as (1) unwarranted assurances or predictions about the future direction of interest rates, (2) inappropriate representations about the "cash savings" to be realized from nontraditional mortgage products in comparison with amortizing mortgages, (3) statements suggesting that initial minimum payments in a payment option ARM will cover accrued interest, or principal and interest, charges and (4) misleading claims that interest rates or

payment obligations for these products are "fixed."

Control Systems. Institutions should develop and use strong control systems to ensure that actual practices are consistent with their policies and procedures, for loans that the institutions originate internally, for loans that the institutions originate through mortgage brokers and other third parties, and for purchased loans. Lending personnel should be trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate and balanced manner, and should be monitored through, for example, call monitoring or mystery shopping, to determine whether they are conveying appropriate information. Attention also should be paid to appropriate legal review and to using compensation programs that do not improperly encourage originators to direct consumers to particular products.

REQUEST FOR COMMENTS.

The Agencies request comment on all aspects of the proposed Guidance. Comment is specifically requested on the following:

1. Should lenders analyze each borrower's capacity to repay the loan under comprehensive debt service qualification standards that assume the borrower makes only minimum payments? What are current underwriting practices and how would they change if such prescriptive guidance is adopted?

2. What specific circumstances would support the use of the reduced documentation feature commonly referred to as "stated income" as being appropriate in underwriting nontraditional mortgage loans? What other forms of reduced documentation would be appropriate in underwriting nontraditional mortgage loans and under what circumstances? (Commenters are requested to include specific comment on whether and under what circumstances "stated income" and other forms of reduced documentation would be appropriate for subprime borrowers.)

3. Should the Guidance address the consideration of future income in the qualification standards for nontraditional mortgage loans with deferred principal and, sometimes, interest payments? If so, how could this be done on a consistent basis? Also, if future events such as income growth are considered, should other potential events also be considered, such as increases in interest rates for adjustable rate mortgage products?

terial conditions that comprise the credit product in question. If, after examining the entire context, the court determines that the 'offer' was a guise for solicitation rather than a legitimate credit product, the communication cannot be considered a firm offer of credit." In assessing whether an offer has "value," the Court held that the amount of credit being offered is only part of the equation. "The terms of an offer, such as the rate of interest charged, the method of computing interest and the length of the repayment period, may be so onerous as to deprive the offer of any appreciable value."

Accordingly, in attempting to defeat class certification in *Murray*, the lender argued that class treatment of plaintiff's firm offer of credit claim was not appropriate because the *Cole* Court's shift in focus to the recipient's belief as to the "value" of the offer required an inquiry into the "value" assigned to the offer by each of the purported 1.2 million recipients, thus clearly making class treatment impractical. The Seventh Circuit rejected that argument, stating that "[n]othing in *Cole* requires an offer's value to be assessed *ex post*, and recipient by recipient. To decide whether GMACM has adhered to the statute, a court need only determine whether the four corners of the offer satisfy the statutory definition (as elaborated in *Cole*), and whether the terms are honored when consumers accept. These questions readily may be resolved for a class as a whole."

Murray is just one of scores of cases that were filed on the heels of the *Cole* decision, primarily in the Northern District of Illinois. At least one other court in that judicial district has already certified a class (*Murray v. New Cingular Wireless Services, Inc.*, 2005 WL 3115813 (N.D. Ill. Nov. 17, 2005), and there are class certification motions pending before several other courts in that district.

While the Court's ruling makes defending firm offer of credit cases particularly challenging in that Circuit, it is wholly unclear whether other courts will embrace the Seventh Circuit's interpretation of what Congress meant by a "firm offer of credit."

States: Licensing Update

KANSAS – Supervised Lender Net Worth and Surety Bond Requirements

Effective January 6, 2006, the minimum net worth requirement for Supervised Lender Licensees that make loans secured by real property is \$250,000. Licensees must maintain the lesser of \$100,000 or 20% of their net worth in liquid assets. Furthermore, on or before January 1 of each year, Supervised Lender Licensees must submit a complete financial statement prepared within the previous year, accompanied by a written statement from a certified public accountant attesting that the statement has been reviewed by such accountant and that it is in compliance with generally accepted accounting principles. Also effective January 6, 2006, Supervised Lender Licensees that make loans secured by real property are required to maintain surety bond coverage in the amount of \$250,000 for a licensee's principal location, and an additional \$25,000 for each licensed branch office.

LOUISIANA – Emergency Advisory Regarding Residential Mortgage Lender Licensees

Pursuant to an Emergency Advisory Bulletin issued January 3, 2006, effective August 29, 2005, certain requirements pertaining to branch address changes, employment changes, late renewal penalty fees, and continuing education are waived. Specifically, in the affected parishes of Jefferson, Lafourche, Orleans, Plaquemines, St. Bernard, St. Charles, St. John the Baptist, St. Tammany, Tangipahoa, Washington, Acadia, Allen, Beauregard, Calcasieu, Cameron, Desoto, Iberia, Jefferson Davis, Sabine, St. Mary, Terrebone, Vermillion, and Vernon ("Affected Parishes"), the Office of Financial Institutions ("Office") has waived the requirement that Loan Originators complete 10 hours of continuing education in order to renew their 2006 Loan Originator License for those individuals that were domiciled in the Affected Parishes immediately prior to Hurricanes Katrina and Rita. The Office also has waived the requisite notice for branch address changes for locations in the Affected Parishes, but licensees shall mail, fax, or otherwise submit the following information to the Office as soon as practicable: (1) the name and physical address of any closed location; (2) the name, physical address, and telephone number of any new location; and (3) the name and contact information for the branch manager at the new location. In those instances where closure of a branch location was a result of the Hurricanes or their aftermath, the Office has waived the closure fee and the requirement that notice be provided within 30 days of closure. Furthermore, the Office has also waived penalty fees for late renewals of entities in the Affected Parishes if such renewal was tardy as a result of the Hurricanes or their aftermath. The Emergency Advisory expires on June 30, 2006.

New Jersey Increases Amount for High-Cost Home Loans

The New Jersey Department of Banking and Insurance increased the maximum principal loan amount for high-cost home loans to \$383,682.60 for 2006. The New Jersey Home Ownership Security Act of 2002 ("the Act") does not apply to mortgage loans above this dollar amount. If a loan is in an amount of \$383,682.60 or less, it must be further reviewed under the Act's APR and points and fees tests in order to determine if it is a high cost home loan under the Act. The increased loan amount in New Jersey is effective for all completed applications received by a mortgage lender on or after January 1, 2006. Because of the increased loan amount, the Act now will apply to a greater number of loans.

Under the Act, the dollar threshold of the loan amount necessary for a mortgage loan to be considered under the "high cost home loan" APR and points and fees "triggers" is adjusted annually. The adjustment of the loan size limit is based on the last published increase in the housing component of the national Consumer Price Index for the New York-Northeastern New Jersey Region. The Department of Banking and Insurance will review the maximum principal loan amount again at the end of 2006 using the same methodology to determine if an adjustment is required to comply with the provisions of the Act.

Currently, twenty-eight states and the District of Columbia have "HOEPA-like" high-cost home loan laws or regulations. Like New Jersey, seven other states (Arkansas, California, New Mexico, New York, North Carolina, South Carolina and Pennsylvania) define a high-cost home loan based in part on the loan size (i.e., the dollar amount of the mortgage loan). In these other states, the dollar thresholds of the loan amount are as follows: (i) Arkansas - \$150,000; (ii) California - the conforming loan size limit for a first lien single-family dwelling as established by FNMA, which limit currently is \$417,000, (iii) New Mexico - tied to the FNMA conforming loan size limit for a single family dwelling, currently \$417,000, (iv) New York - \$300,000, (v) North Carolina - \$300,000, (vi) South Carolina - tied to the FNMA conforming loan size limit for a single family dwelling, currently \$417,000,

and (vii) Pennsylvania - \$100,000. In these states, if the loan amount is in excess of the respective loan size limit, a lender need not consider the loan under the high cost home loan APR and "points and fees" triggers. However, in addition to New Jersey, in the following states, the dollar amount for the loan size limit for high cost home loan purposes is subject to upward adjustment: California, New Mexico and South Carolina, thus potentially increasing the number of covered loans in these states in the future.

Federal Courts Rule Against Private Right of Action for TCPA

The United States District Court for the Southern District of New York and the United States District Court for the District of Columbia recently dismissed claims asserted under the Federal Communication Commission's ("FCC") regulations implementing the Telephone Consumer Protection Act of 1991 ("TCPA"), holding that recipients of unsolicited facsimile advertisements do not have a private right of action to recover statutory penalties for advertisers' failure to abide by the FCC's fax identification requirements. The opinions released in both cases break a trend among state trial courts finding that such a right is available to private litigants.

THE TCPA'S LEGAL FRAMEWORK

The TCPA provides an express private right of action at 47 U.S.C. § 227(b) for recipients of fax advertisements that were sent without the recipients' prior express permission, and where the advertiser did not have an established business relationship with the recipient. The TCPA further provides at 47 U.S.C. § 227(d) that it is unlawful to send a fax unless the sender "clearly marks, in a margin at the top or bottom of each transmitted page of the message or on the first page of the transmission, the date and time it is sent and an identification of the business, other entity, or individual sending the message and the telephone number of the sending machine or of such business, other entity, or individual." Unlike Subsection (b), however, Subsection (d) does not provide an express private right of action.

The FCC promulgated regulations at 47 C.F.R. § 68.318(d) implementing

corresponding fax identification requirements. In a 2003 issuance, the FCC stated that it had promulgated this particular regulation under the authority of 47 U.S.C. § 227(d). In the same issuance, the FCC declined "to make any determination about the specific contours of the TCPA's private right of action," opining that "it is for Congress, not the Commission, to either clarify or limit this right of action."

NO PRIVATE RIGHT OF ACTION

Against this legal framework, the plaintiffs in *Klein v. Vision Lab Telecommunications, Inc.*, a case decided in November 2005 by a New York federal district court, and in *Adler v. Vision Lab Telecommunications, Inc.*, a case decided in October 2005 by the District of Columbia federal district court, each purported to be recipients of unsolicited facsimile advertisements that did not properly identify the individual or entity that sent the advertisements, or the telephone number of the sending machine. In addition to claims predicated on 47 U.S.C. § 227(b), both plaintiffs asserted causes of action based on Subsection 68.318(d) of the FCC regulations. On motions to dismiss, the defendant (which had been sued in both cases) argued that the FCC regulation in question had been promulgated under 47 U.S.C. § 227(d), not 47 U.S.C. § 227(b), and, therefore, did not permit a private cause of action.

Both courts agreed with the defendant. The *Klein* court stated that it "cannot understand how language governing technical fax requirements in § 227(d), a section that contains no language permitting a private right of action, suddenly bestows a private right of action when it is redrafted into an FCC regulation that fails explicitly to identify the subsection under whose authority it was promulgated." The *Klein* court further noted that while "the technical and procedural standards are designed to make it easier to identify the offending sender," it is nonetheless "the province of the state attorneys general and the FCC to sue fax broadcasters for technical violations."

Citing the plain language of the statute, the *Adler* court reached a similar conclusion, reasoning that the private right of action established by 47 U.S.C. § 227(b) "limits the right to 'an action based on a violation of *this subsection* [i.e., subsection (b)] or the regulations

prescribed under this subsection.” (Emphasis in original.) Like the *Klein* court, the *Adler* court noted that the FCC regulation in question “was issued pursuant to a directive in § 227(d). . . . Section 227(b) deals with unsolicited faxes, not improperly identified faxes. A private right of action exists only with respect to the former.”

Klein and *Adler* appear to have been cases of first impression in the federal courts. Previous unpublished state trial court opinions, however, have reached

opposite conclusions, including *Yavitch & Palmer Co. v. U.S. Four, Inc.* (from an Ohio state municipal court), *McKenna v. Accurate Computer Service, Inc.* (from a Colorado state district court), and *Schraut v. Rocky Mountain Reclamation* (from a Missouri state circuit court). For example, in *Schraut*, the state court found that 47 C.F.R. § 68.318(d) was privately actionable, contending that “[c]onsumers had a right to be free from unsolicited advertising faxes, and they also have a right to receive proper iden-

tification on all faxes. A consumer who receives a call or fax violating multiple rights provided under the TCPA should recover for each right violated.” The *Adler* court, however, specifically criticized the *Schraut* opinion, observing that “the *Schraut* court did not analyze or even recognize the limitation in § 227(b)(3)(A) to ‘regulations prescribed under this subsection.’” (Emphasis in original.)

Decisions by other courts on this issue are to be expected.

States: Legislation and Rulings

CALIFORNIA - Federal Court Stays California's Strict Restrictions on the Transmission of Unsolicited Facsimiles

On December 21, 2005, the United States District Court for the Eastern District of California issued an order provisionally staying California's unsolicited fax ban until January 31, 2006, pending a hearing on January 23, 2006. *Chamber of Commerce v. Lockyer*, E.D. Cal., 2:05-CV-02257-MCE-KJM. On January 23, 2006, the court conducted a hearing, and in order to provide more time to consider the issue, the court extended its provisional stay of the ban from January 31, 2006 until February 27, 2006. The ban, which would prevent companies from transmitting unsolicited faxes from or to a recipient located in California when the recipient has not previously provided written consent, was scheduled to become effective January 1, 2006.

By way of background, California Business & Professions Code section 17538.43, introduced as Senate Bill 833 and signed into law by the Governor on October 7, 2005, affords more protection to the recipients of unsolicited facsimiles than does the federal Junk Fax Protection Act of 2005. The Junk Fax Protection Act was signed into law by President Bush on July 9, 2005, and amends the Telephone Consumer Protection Act of 1991 (“TCPA”), 47 U.S.C. § 227, regarding the sending of unsolicited advertisements by facsimile. Federal law permits a sender to send facsimile advertisements to recipients with whom they have an “established business relationship” as long as those advertisements provide an opportunity for the recipient to opt-out of the receipt of such faxes. California's equivalent state law does not provide such an established

business relationship exception and instead requires a sender to obtain express prior consent before transmitting any facsimile advertisement into or out of California.

In mid-December 2005, the U.S. Chamber of Commerce (the “Chamber”) filed a motion requesting provisional stay of the California unsolicited fax ban. The Chamber argued that, unlike federal law, the California ban contains no exception for organizations that maintain an established business relationship with their patrons. Although section 227(e) of the TCPA expressly provides that the TCPA shall generally not preempt state law that imposes more restrictive intrastate requirements or regulations concerning the sending of unsolicited fax advertisements, the Fax Ban Coalition filed a petition for a declaratory ruling from the Federal Communications Commission (“FCC”), asking the FCC to preempt state statutes governing interstate communication by fax. The matter is pending before the FCC, and a Public Notice of Proposed Rulemaking by the FCC has been published in the Federal Register, with comments due by mid-January 2006. A favorable ruling from the FCC on the Fax Ban Coalition would preempt California law and also prevent any other state from enacting laws inconsistent with the federal laws restricting interstate communication by fax.

Although the majority of states do not currently regulate the transmission of unsolicited faxes, more states have begun to regulate in this area, and it remains to be seen whether other states will adopt California's position, which provides more protection to recipients than the Federal Junk Fax Prevention Act of 2005, but which also impedes communications by not recognizing an established business relationship exception to the ban on unsolicited faxes.

Sixth Circuit Holds that the National Bank Act's Implementing Regulations Preempt Conflicting State Law

The United States Circuit Court of Appeals for the Sixth Circuit recently held – as have the United States Second and Ninth Circuit Courts of Ap-

peals – that regulations implementing the National Bank Act preempt conflicting state laws regarding oversight of national banks' operating subsidiaries.

In its December 19, 2005, decision in *Wachovia Bank v. Watters*, the Sixth Circuit affirmed the United States District Court for the Western District of Michigan ruling that Michigan state laws that would require Wachovia Mortgage -- an operating subsidiary of Wachovia Bank -- to register with the

State, provide financial statements to the State, and pay operating fees to the State, among other things, were preempted by the National Bank Act's implementing regulations (the "Regulations").

After being advised by the State of Michigan that Wachovia Mortgage would no longer be authorized to conduct mortgage lending activities in the State if it surrendered its "lending registration" there, Wachovia filed a declaratory action, seeking a ruling that

the Michigan laws at issue were preempted and did not apply to operating subsidiaries of a national bank. The Sixth Circuit agreed, noting that the Regulations, among other things, (1) permit an operating subsidiary of a national bank to conduct the same banking activities as the national bank, (2) direct that the "authorization, terms and conditions" that apply to a national bank apply equally to an operating subsidiary acting under the Regulations, and (3) provide that state laws apply to such an operating subsidiary to the same extent that they apply to its parent national bank.

In so holding, the Sixth Circuit rejected the State's arguments that the Regulations could not preempt state law without Congress's express permission and that the Comptroller exceeded its authority in promulgating the Regulations. In so doing, the Court noted that where the preemption at issue was "conflict preemption" – that is, preemption based on the state law standing as an obstacle to the accomplishment of Congress' objectives – the proper test is whether the Comptroller exceeded its authority or acted arbitrarily when promulgating the Regulations. In rejecting the State's argument that the Comptroller exceeded its authority by impermissibly expanding the definition of "national bank" under the Act to include oper-

CONSENT ORDER FOLLOWS RECENT PREEMPTION DECISIONS

The United States District Court for the District of New Jersey approved a settlement reached by National City Bank of Indiana ("NCB") and the Commissioner of the New Jersey Department of Banking and Insurance ("Commissioner") and entered a consent order, enjoining the Commissioner from exercising any visitatorial authority over NCB and its mortgage company operating subsidiaries, First Franklin Financial Corporation and National City Mortgage Co. The consent order resolves an action, brought by NCB against the Commissioner, in which NCB asserted that the Commissioner's visitatorial powers, including authority to license, regulate, examine, supervise, or exercise enforcement authority over NCB's banking activities, whether conducted directly by NCB or through its operating subsidiaries, was preempted by exclusive visitatorial powers of the Officer of the Comptroller of the Currency ("OCC"). NCB's operating subsidiaries held lender licenses in New Jersey. Pursuant to the terms of the consent order, NCB agreed to surrender the licenses of its operating subsidiaries to the Commissioner. Upon such surrender, the Commissioner becomes permanently enjoined from exercising any visitatorial authority over NCB and its operating subsidiaries. The settlement follows recent decisions by the United States Circuit Court of Appeals for the Ninth Circuit in *Wells Fargo Bank N.A. v. Boutris*, No. 03-16194 and by United States Circuit Court of Appeals for the Second Circuit in *Wachovia Bank N.A. v. Burke*, No. 04-3770. In *Boutris*, the court concluded that the California Commissioner of Corporations is preempted from ordering regulatory audits on national bank operating subsidiaries and that state lending licensing requirements as applied to operating subsidiaries of national banks are field-preempted. In *Burke*, the court similarly held that federal law preempts the application of certain Connecticut state banking laws to a national bank operating subsidiary to the same extent that it preempts regulation of its parent national bank. NCB and the Commissioner expressly reserved the right to modify the consent order, should the *Burke* and *Boutris* decisions be reversed or modified by subsequent judicial or legislative action. Thus far, in a decision that came out the same week as the entry of the consent order, the Sixth Circuit, in *Wachovia Bank N.A. v. Watters*, No. 04-2257, joined the United States Second and Ninth Circuit Courts of Appeals in holding that the National Bank Act and regulations promulgated by the OCC preempt Michigan laws concerning operating subsidiaries of nationally chartered banks. See the preceding article on *Wachovia Bank N.A. v. Watters*, No. 04-2257.

ating subsidiaries, the Court held that the Regulations merely interpret the term “incidental powers” under the Act to include a national bank’s power to conduct business through an operating subsidiary. The Court further reasoned that to hold otherwise would obstruct a bank’s power under the Act to conduct “the business of banking.” The Court then concluded that the Comptroller’s Regulations represent a reasonable construction of the statute and, therefore, are entitled to deference.

Finally, the Court noted that the State’s argument that this holding will preclude it from protecting its citizens from such operating subsidiaries is irrelevant to the preemption analysis. Quoting the Supreme Court, the Sixth Circuit held that it is not for the Court to evaluate the wisdom or need for a state’s laws but rather to enforce the compact between state and federal governments, which mandates preemption in these circumstances.

Supreme Court Decides Citizenship Of National Banks

In a recent decision, the United States Supreme Court resolved a split between the United States Circuit Courts of Appeals and decided that for diversity purposes a national bank is a citizen of the state where its main office is located.

The Supreme Court ruling in *Wachovia Bank, N.A. v. Schmidt* resolved a split between the United States Courts of Appeals for the Fifth and Seventh Circuits and the United States Courts of Appeals for the Second and Fourth Circuits. The Fifth and Seventh Circuits had decided that a national bank was located solely in the district where its main office was located. The Second Circuit (in dictum), and more recently the Fourth Circuit had decided that a national bank was located in every state where it had branches.

In an unqualified rejection of the Fourth Circuit, the Supreme Court interpreted the jurisdictional provision of the National Bank Act, 28 U.S.C. §1348, to mean that a national bank is a citizen of the state where its main office is located, “as set forth in its articles of association.” In coming to this

conclusion, the Supreme Court: (1) analyzed the historical development of legislation leading to 28 U.S.C. §1348 in its present form; (2) reasoned that national banks should have access to the federal courts’ diversity jurisdiction similar to that enjoyed by state chartered banks and corporations; and (3) rejected the three reasons on which the Fourth Circuit relied.

NATIONAL BANKS’ HISTORICAL ACCESS TO FEDERAL COURTS

The Supreme Court explained the history of national banks’ access to federal court jurisdiction. Initially, national banks could bring suit in federal court under a legislative grant of original jurisdiction. Thus, national banks could “sue and be sued in the federal district and circuit courts solely because they were national banks, without regard to diversity, amount in controversy or the existence of a federal question in the usual sense.”

Congress then withdrew generalized access to the original jurisdiction, and put national banks, more or less “on the same footing” as the banks of the state where they are located in 1882.

Additional legislative refinements (without substantive changes) took place in 1887, 1911, and finally 1948, when the current statutory language was adopted. 28 U.S.C. §1348. During this entire timeframe, from 1863 until 1948, a national bank was effectively restricted, except for two limited grandfathered exceptions, to having branches only in the state where its main office was located. Consequently, the language in §1348 was never parsed for the jurisdictional meaning of “located,” until interstate banking became a practical reality. In this historical context, the Supreme Court did not think that Congress intended the “incongruous outcome” of having national banks reduce their access to federal court diversity jurisdiction by simply engaging in interstate branch banking operations.

UNEQUAL IMPEDIMENTS

The Supreme Court was obviously concerned over the practical effect of the Fourth Circuit’s decision. In comparison with state banks and corporations, the holding by the Fourth Circuit would fall unequally on national banks. Specifically, a corporation is not

a citizen (within the meaning of 28 USC § 1332(a)(1)) of every state where it has an office. Rather, a corporation is a citizen of only two states, at most — the state of incorporation and the state of its principal place of business, if different. By contrast, Wachovia would be a citizen of sixteen states under the Fourth Circuit’s reasoning.

The Supreme Court also acknowledged the possibility that a national bank’s “main office,” as designated in its articles of association, might be in a state other than the one where its principle place of business was located. Consequently, the door appears to be still open, or at least slightly ajar, for additional litigation on the narrow issue of whether a national bank could also be a citizen of the state where its principle place of business is located, if its “main office” is located in a different state.

REJECTION OF THE FOURTH CIRCUIT

According to the Supreme Court, the Fourth Circuit articulated three primary, but faulty bases for its decision. First, the Fourth Circuit reasoned that the term “located” means physical presence, but that reasoning leads to more unresolved issues. Second, the Fourth Circuit attempted to give distinct meanings to the terms “established” and “located” in 28 U.S.C. §1348, but the terms are actually more synonymous than different. Third, the Fourth Circuit should not have interpreted “located,” in a manner that was consistent with historical venue statutes for national banks, along with the corresponding case law.

As for the normal or “common parlance” meaning of the term “located,” the Supreme Court was unimpressed with this logic. The Opinion identifies several statutory provisions relating to national banks and found the term “located” used interchangeably in some provisions for the bank’s main office, and for branches in others. The Court was also troubled by the Fourth Circuit’s reliance on “physical presence” as a touchstone, because offices and operations, other than branches, could be physically present in various states. There would, therefore, remain unresolved issues as to what other types of “physical presence,” such as ATMs, could affect citizenship.

As for the dichotomy presented by the terms “located” and “established”, it is important to note that national banks still have access to the original jurisdiction of the federal courts for limited types of lawsuits, where the national bank is “established;” *e.g.* actions concerning the windup of the affairs of the national bank, and actions by the national bank against the Comptroller of the Currency or its receivers. “[F]or purpose of all other actions . . .,” national banks are citizens of states where they are located, the Supreme Court noted.

In attempting to give a separate meaning to the terms “established” for original jurisdiction, and “located” for purposes of citizenship concerning other actions, the Fourth Circuit reasoned that different words should be given distinct meanings. The Supreme Court, however, viewed the use of different words as an accident of legislative drafting. At the time of codification of the relevant language, national banks were “almost” (but not entirely) uniformly located in the state where they were established. Consequently, the Supreme Court felt that the words “located” and “established” should be more readily synonymous than distinct.

As for interpreting the term “located” for purposes of diversity jurisdiction, consistently with the venue statute, the Supreme Court stated that the Fourth Circuit’s analysis was erroneous. The Supreme Court reasoned that venue and subject matter jurisdiction are fundamentally different concepts. Consequently, the term “located” for venue should not be construed in the same way

as for subject matter jurisdiction. Further, venue often allows for suits in a number of places (typically counties within states), whereas federal court diversity jurisdiction is limited to two different states, at most, for many corporations.

In sum, the Supreme Court has decided for federal court jurisdictional purposes, that a national bank is a citizen of *only* the state where its main office is located, according to its articles of association. The Supreme Court has also assumed, in dicta, that the principal place of business for a national bank is located in the same state as the main office, but future litigation may test the validity of that assumption.

Appellate Court Rules Attorneys Are Not Financial Institutions

Attorneys engaged in the practice of law are not “financial institutions” subject to the Gramm-Leach-Bliley Act (“GLBA”) provisions imposing privacy restrictions on consumer financial information, according to the United States Circuit Court of Appeals for the District of Columbia Circuit.

The appellate court made the ruling December 6, 2005, in *American Bar Association v. Federal Trade Commission*.

GLBA, approved by Congress in 1999, imposes certain privacy requirements on “financial institutions.” After rulemaking, proceedings, the FTC issued regulations related to GLBA in 2000 that defined a financial institution

as “an institution that is significantly engaged in financial activities.”

Based upon the breadth of the regulation and public statements made by the FTC, the American Bar Association and the New York State Bar Association asked whether the FTC intended to attempt to use GLBA to regulate attorneys in the practice of law. When the FTC’s response made clear that the FTC did intend to do so, the bar associations filed suit. The district court granted summary judgment for the bar associations, holding that Congress did not intend GLBA’s privacy limits to apply to attorneys engaged in the practice of law. The FTC appealed, contending that its interpretation was entitled to deference under the standards set out by the Supreme Court in *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*

The appellate court began its *Chevron* analysis by stating the plain language of the statute did not expressly give the FTC the right to regulate practicing attorneys. The court then found that (1) there was no ambiguity in the statute that permitted the FTC’s proposed interpretation and (2) in any event, the FTC’s interpretation was not reasonable. As the court put it: “The states have regulated the practice of law throughout the history of this country: the federal government has not. This is not to conclude that the federal government could not do so. We simply conclude that it is not reasonable for an agency to decide that Congress has chosen such a course of action in language that is, even charitably viewed, at most ambiguous.”



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