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MEMORANDUM

February 27, 2003

To Our Clients and Friends

Re: OCC Supervisory Guidance on Predatory and Abusive Lending Practices

The Office of the Comptroller of the Currency (“OCC”) has issued supervisory guidance for national banks and their operating subsidiaries to guard against predatory and abusive lending practices.¹ The guidance applies to loans that national banks originate, broker, or purchase.

The OCC believes loans reflecting abusive lending practices² may involve unfair and deceptive practices in violation of section 5 of the Federal Trade Commission Act. In addition, the OCC states that many types of abusive lending practices may also violate the Home Ownership and Equity Protection Act (“HOEPA”), the Truth in Lending Act, and the Real Estate Settlement Procedures Act, and may adversely affect the evaluation of a bank’s performance under the Community Reinvestment Act.

¹ A fundamental characteristic of predatory lending is the aggressive marketing of credit to prospective borrowers who cannot afford the credit on the terms being offered. Typically, such credit is underwritten predominantly on the basis of the liquidation value of the collateral, without regard to the borrower’s ability to service and repay the loan according to its terms absent resorting to that collateral.

² Examples of predatory practices are “equity stripping” (making loans with excessively high, up-front fees that are financed and secured by the borrower’s home, often with an excessively high penalty upon prepayment of the loan, for the primary objective of stripping the borrower’s home equity); “loan flipping” (sequential refinancings that result in little or no economic benefit to the borrower and are undertaken with the primary objective of generating additional loan fees, prepayment penalties, and fees from the financing of credit-related products); refinancing of special subsidized mortgage loans that result in the loss of beneficial loan terms; “packing” of excessive and sometimes hidden fees in the amount financed; using loan terms or structures to make it more difficult or impossible for borrowers to reduce or repay their indebtedness; balloon payments, inadequate disclosure of true costs, risks and appropriateness to the borrower of the loan transaction; targeting inappropriate or excessively expensive products to older borrowers and to persons who are not financially sophisticated; the offering of single premium credit life insurance; and use of mandatory arbitration clauses.

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The OCC intends to review credible evidence that a national bank has engaged in abusive lending practices and where such practices are found to violate an applicable law or safety and soundness standard, it will take appropriate supervisory action.

AVOIDING PREDATORY LENDING PRACTICES IN DIRECT LOAN ORIGINATIONS

The OCC advises national banks to have policies and procedures in place to prevent the bank and its subsidiaries from engaging in practices that may be considered predatory or abusive.

- *Underwriting policies* – National banks are to adopt policies and procedures to ensure that the borrower has the capacity to make scheduled payments to service and repay the loan, including principal, interest, insurance and taxes, based on the borrower's:
 - current and expected income;
 - other relevant financial resources;
 - employment status; and
 - current financial obligations, including other indebtedness.

- *Policies addressing risk of abusive practices* – National banks should consider adopting clear policies and procedures to specify whether and under what circumstances the bank will make loans with features that have been associated with abusive lending practices, including:
 - frequent, sequential refinancings;
 - refinancings of special subsidized mortgages that contain terms favorable to the borrower;
 - single-premium credit life insurance or similar products;
 - negative amortization;
 - balloon payments in short-term transactions;
 - prepayment penalties that are not limited to the early years of a loan;
 - financing points, fees, penalties and other charges;
 - interest rate increases upon default;
 - mandatory arbitration clauses; and
 - making loans subject to HOEPA.

Borrowers should be provided with the information necessary to enable them to determine whether the loan meets their financial circumstances and needs. Banks should have policies to help ensure that interest rates and pricing terms for their loans reasonably reflect the costs and risks of making such loans and are consistent with OCC regulations. Banks are

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encouraged to adopt policies and procedures that provide for reporting of good credit histories to the credit bureaus.

- *Policies concerning appropriateness of certain transactions* – National banks should adopt policies and procedures that ensure that lending practices reflect the degree of care that is appropriate to the risk, considering such factors as:
 - the sophistication or expertise of the borrower in credit transactions;
 - the need for, and proposed use of, the loan proceeds;
 - the borrower’s understanding of how the loan meets the borrower’s financial circumstances; and
 - the bank’s assessment of the terms and conditions of the loan relative to those needs.
- *Loan Quality Control Reviews and Corrective Action* – National banks should periodically perform a documentation review on a random sampling of transactions to ensure that transactions comply with bank policies and legal requirements. If a particular risk has been identified, banks should conduct a more comprehensive review.

AVOIDING PREDATORY LENDING PRACTICES IN BROKERED AND PURCHASED LOANS³

The OCC advises a national bank that its policies and procedures relating to brokered and purchased loans should ensure that the loans it obtains comport with the bank’s general lending and other policies applicable to loans that the bank makes directly, and with applicable safety and soundness standards and consumer protection laws. Specifically, a national bank should undertake the following:

- *Policies and procedures* – Establish clear procedures for entering into and continuing relationships with third-party mortgage loan brokers and originators, and standards that delineate underwriting and appraisal requirements and unacceptable characteristics for brokered and purchased loans. The policies should delineate the circumstances under which the bank will make through a broker or acquire in a purchase transaction, loans with features that have been associated with abusive lending practices. (See page 2 above for examples of possible abusive practices.)

³ This guidance applies to (1) traditional broker transactions in which a mortgage broker refers an application to the bank and the loan is closed in the bank’s name; (2) “table funded” loans that are closed in the name of a third party, but in which the bank provides the loan funds and immediately acquires the loan; and (3) loan purchase transactions where the loan is initially made and funded by a third party who subsequently sells the loan to the bank (whether or not the bank performs or participates in the underwriting of the loan.)

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Policies should also address:

- the maximum points and other charges that may be imposed on brokered and purchased loans, as well as the use of overages and yield-spread premiums as compensation vehicles;
 - the total compensation to the broker and the lender, and establish limits on broker compensation;
 - interest rates and other pricing terms for brokered and purchased loans so that they reasonably reflect the costs and risks of making loans; and
 - the need for strong and appropriate controls over all mortgage origination functions.
- *Due Diligence* – National banks should perform through due diligence before entering into relationships with mortgage brokers or third-party originators. This should include a review of the third party's:
 - general competence;
 - business practices and operations, including potential conflicts of interest;
 - reputation;
 - financial capacity and condition;
 - internal controls; and
 - record of compliance with applicable licensing, consumer protection, and other laws.

Through this review, which should also include a risk assessment and an assessment of any litigation, enforcement actions, or pattern of consumer complaints, the national bank should develop an approved list of mortgage brokers and third-party originators.

- *Broker and Originator Agreements* – National banks should have written agreements with mortgage brokers and originators that address the rights and responsibilities of each party. These agreements should:
 - address the bank's lending policies and should contain the third party's express agreement to abide by these policies;
 - ensure that no inappropriate compensation incentives exist to induce brokers or originators to treat borrowers in a discriminatory manner, or otherwise unfairly;
 - provide for indemnification to the bank upon breach of the agreement;
 - enable banks to exit the arrangement through clear termination rights and procedures;

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- provide for the bank's (and the OCC's) ability to access all records of the third party necessary to enforce and ensure compliance with the agreement and to audit the third party's operations; and
- stipulate clear minimum performance standards and service levels.

In these agreements brokers and originators should specifically agree:

- to comply with all applicable laws, including safety and soundness regulatory standards applicable to national banks and laws prohibiting lending discrimination and unfair or deceptive practices; and
 - to make best efforts to ensure that the loans offered to borrowers are consistent with their needs, objectives and financial situation.
- *Individual Loan Review* – National banks should verify that brokers and originators have established policies and procedures sufficient to ensure that loans to be originated or purchased by the bank will comply with applicable laws and the bank's policies. Banks should conduct appropriate documentation review to ensure compliance. With respect to brokered loans, the bank should have a process for reviewing written agreements between the borrower and the broker to ensure that fees are disclosed, that there is a request for broker services at that fee and that there is a signed and dated acknowledgment of receipt by the consumer.
 - *Monitoring and Management Information System* – National banks need effective management information systems to monitor the performance of brokers and originators. Monitoring should include compliance with the terms of the contract, with OCC guidance on risk management principles for third-party relationships and with applicable laws and bank policies. In addition, national banks should adopt criteria and procedures for additional targeted reviews of brokers and originators who present heightened risk.
 - *Corrective Action* – National banks should take prompt and appropriate corrective action, including modification of loan terms and termination of the relationship with the third party, when the third party is found to have violated bank policies, applicable laws, or the provisions of the agreement with the national bank.

The text of this supervisory guidance can be found at www.schwartzandballen.com/WhatsNew.htm.

If you have any questions concerning the OCC's guidance, please call Gilbert Schwartz, Robert Ballen or Tom Fox at (202) 776-0700.