INTRODUCTION TO MORTGAGE LENDING

Third Edition

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AMERICAN BANKERS ASSOCIATION ®

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Printed in the United States of America.
10 9 8 7 6 5 4 3 2

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Preface

This book is a guide for professionals engaged in the mortgage lending sector of the banking business. Its publication reflects the American Bankers Association's long tradition of providing education for the benefit of its members, their employees, and others interested in gaining a better understanding of the banking business.

Understanding the legal requirements of state and federal laws is an important responsibility of bank employees, not only to avoid receiving negative bank examination reports but also to avoid civil liability and reputational damage for their institutions. In recent years, class action lawyers have actively pursued alleged violations of consumer protection laws by mortgage lenders. These lawsuits are expensive to defend, regardless of the outcomes. The best defense against such challenges is to have a strong compliance program in place. Any such program must include employee education in both the financial and regulatory aspects of the mortgage lending business.

Over the years, the American Bankers Association (ABA) has been a leader in educating bankers and the public about the opportunities and challenges of mortgage lending. The partners in our Washington, DC–based law firm, Buckley Sandler, LLP, have worked closely with ABA staff on mortgage lending issues. We value our relationship with the ABA and the mortgage lending industry and appreciate the opportunity to collaborate with the ABA in producing this book.

The volume is current as of May 1, 2009. Since it was written, new legal and regulatory initiatives have undoubtedly emerged. Many members of Congress are seeking remedial statutes to address the ever-rising tide of foreclosures, some of which may have been enacted into law, and additional government programs may have been adopted to help the housing finance economy find a firmer footing for the next decade. Because legistlation and regulatory initiatives are changing so quickly, it is critical that readers check amendments in law or public policy that occurred after May 1.

About the Authors

Andrea Lee Negroni (Lee) is a nationally known attorney in the field of regulatory compliance for the residential mortgage lending industry. She has advised mortgage lenders, mortgage brokers, and related service providers on virtually every substantive area of state mortgage banking law. Ms. Negroni is the author of *Residential Mortgage Lending: State Regulation Manual* and *Residential Mortgage Lending: Brokers,* co-author of *Pratt's State Regulation of Second Mortgages and Home Equity Loans,* and the author of more than 50 articles on consumer credit regulation and related subjects. She has served as a member of the Advisory Council of the American Association of Residential Mortgage Regulators (AARMR), from which she received the Distinguished Service Award in 1997, and was a member of the Board of Governors of the Mortgage Bankers Association of Metropolitan Washington.

Ms. Negroni is of counsel with Buckley Sandler, LLP, a financial services law firm in Washington, DC. Before joining Buckley Sandler, she was a partner at Goodwin Procter, LLP. Between 1992 and 2000, she was the founder and managing partner of Negroni & Kromer, PLLC. She has also been vice president and associate general counsel of The Prudential Home Mortgage Company and counsel and executive vice president of Skyline Financial Services Corporation (predecessor to GE Capital Asset Management Corporation). She is a graduate of the Columbia University School of Law and a member of the District of Columbia and Florida Bar associations.

Jeremiah S. Buckley (Jerry) is a founding partner of Buckley Sandler, LLP, where his practice focuses on consumer financial services and real estate law, with a concentration on federal and state regulation of financial services transactions, including transactions in electronic commerce. He advises financial services firms on compliance with state and federal regulations on lending, licensing and chartering, mergers, conversions, investments, deposit taking, transactions with affiliates, and holding company operations. He also advises mortgage companies and other settlement services providers on compliance with the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act, and related federal and state laws. Mr. Buckley has chaired the Subcommittee on RESPA of the American Bar Association's Consumer Financial Services Committee.

Mr. Buckley's practice also includes the defense of companies in enforcement actions by bank regulatory agencies, the Federal Trade Commission, and the Department of Housing and Urban Development. He has acted as counsel for a number of national financial services trade associations in filing *amicus curiae* briefs related to the interpretation of banking and consumer finance laws in cases before the U.S. Supreme Court and appellate courts.

Mr. Buckley is general counsel of the Electronic Financial Services Council (www.efscouncil.org), which advises the nation's leading financial and technology firms on emerging laws affecting the electronic delivery of financial services. He was counsel to the drafting committee for *Standards and Procedures for Electronic Records and Signatures* (www.spers.org). He is co-author of *The Law of Electronic Signatures and Records* and a frequent speaker at conferences and seminars on financial services regulation.

Before founding Buckley Sandler, Mr. Buckley was a partner with Goodwin Procter, LLP, which he joined after serving as the Republican Staff Director of the U.S. Senate Banking Committee. He earned his law degree at the University of Virginia Law School.

Introduction

One of the principal reasons why banks are chartered by state and federal governments is that they provide credit to their communities. The provision of business credit remains a central aspect of the banking business, although in recent decades the retail financial services sector has gained prominence at banks of all sizes. In the area of mortgage finance, the growth has been significant: between 1990 and 2007, the annual dollar volume of home mortgage debt originated rose from $500 billion to $2.31 trillion, a more than fourfold increase.

EVOLUTION OF MORTGAGE LENDING

Mortgage lending was long a part of banking activity in the United States, but it was not until the 1930s, and the advent of the Federal Housing Administration (FHA), that a market emerged for 20- to 30-year loans with relatively low down payments. Over time, a mortgage market developed in which home loans could be obtained by the average American family with a down payment of 20 percent or less if the FHA, the Veterans Administration (now the Department of Veteran's Affairs), or private mortgage insurance was involved. The resulting expansion of homeownership opportunities was enormous.

The benefits of mortgage credit are now so much a part of American culture that they are sometimes taken for granted, but they are significant. High homeownership rates are an important stabilizing force in communities. As homebuyers secure the "American Dream," they become more productive and committed members of society, increase their purchases of home furnishings and appliances, make home improvements, and accumulate wealth. As mortgage debt is paid down, home equity builds up; with property appreciation, homes often provide substantial nest eggs for retirement.

The role of banks in providing mortgage credit has evolved over time as well. For many decades, banks financed home mortgages through portfolio lending, in which they relied on deposits to fund their loan portfolios. Although these loans proved to be stable and safe investments for the banks' funds, there were disadvantages to banks in borrowing short and lending long, particularly during periods of high inflation. A run-up in interest rates, as occurred periodically when Federal Reserve raised rates, tended to dry up mortgage credit, because until the 1980s, banks operated under ceilings on the amount they could pay for deposits. As a result, money moved to government or private bond markets when rates rose, choking off funds for mortgages. Mortgage lending was a bit of a boom or bust business.

Things changed in the 1980s, as new mortgage securities were invented that granted lenders access to the capital markets through securitization of mortgages. Through inventive financial engineering that involved the division of 30-year mortgages into tranches based on predictable repayment rates (most residential home mortgage loans are repaid in seven years or less), the banking industry and investment banks were able to smooth out the cost of credit and ensure a more stable source of funds for mortgages. Through the secondary market, one of the major financial innovations of the last 30 years, and the creativity of banks, American homeowners were ensured a steady flow of mortgage credit.

As the secondary market emerged, banks continued to play a major but changing role in mortgage finance as originators and servicers of mortgage loans, as purchasers of mortgage securities, and, to a lesser degree, as portfolio lenders (using hedging strategies to reduce the risk of interest rate movements). Some banks also served as providers of so-called wholesale mortgage lending, providing an outlet for loans originated by mortgage brokers and correspondent mortgage bankers.

Unfortunately, over the last few years, the success story of home mortgage finance by America's financial institutions has been marred by an unjustified relaxation of underwriting standards by some lending institutions and secondary market participants, which caused the volume of mortgage defaults to soar. The wave of defaults has had a severe negative impact not only on borrowers but on mortgage holders, including both holders of mortgage-backed securities and portfolio lenders.

What has become known as the subprime mortgage lending crisis is causing severe financial problems for some banks and other mortgage market participants, in both the United States and abroad, in both the housing market and in sectors of the economy that are unrelated to housing. The full impact of these developments is yet to be determined. However, these times remind us that a firm grasp of the basics of mortgage lending, as outlined in this book, will be increasingly important to bankers engaged in mortgage lending in the future.

LEGAL REGULATION OF MORTGAGE LENDING BY BANKS

Bank mortgage lending is highly regulated at both the federal and state levels. As institutions insured by the Federal Deposit Insurance Corporation (FDIC), banks are subject to periodic examinations by their regulators. In addition to examinations for safety and soundness, they are examined for compliance with consumer protection laws.

Starting with enactment of the Truth in Lending Act (TILA) in the late 1960s, Congress enacted a series of consumer protection laws that affect the way bankers engage in mortgage lending. State legislatures have also enacted laws affecting mortgage lending activities. As a result, mortgage lending is among the most heavily regulated businesses in which banks engage. Knowing the laws and the expectations of a bank's regulators is important for bank employees engaged in the mortgage lending business.

Most federal laws affecting mortgage lending were first passed in the 1970s. These include the Real Estate Settlement Procedures Act (RESPA), the Fair Credit Reporting Act (FCRA), the Equal Credit Opportunity Act (ECOA), the Home Mortgage Disclosure Act (HMDA), the Fair Housing Act (FHA), the Community Reinvestment Act (CRA), and the Fair Debt Collections Practices Act (FDCPA). In the years following this spate of new laws, Congress amended and strengthened these laws and added new ones, including the Home Owners Equity Protection Act (HOEPA), the Gramm-Leach-Bliley Act (GLBA) and its privacy provisions, and the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE). Inevitably, additional laws will follow, and current laws will be amended.

States actively seek to protect consumers in their residential mortgage transactions as well. Many of them have enacted mortgage banking and loan originator statutes, antipredatory lending laws, privacy legislation with identity theft and financial data protection provisions and anti-discrimination statutes, which supplement the federal fair housing laws.