small TALK

— by KAVITA GOSWAMY SHELAT —

When the Consumer Financial Protection Bureau (CFPB) opened its doors in 2011, a primary focus for its rule making and enforcement actions was the mortgage industry. Four years later, mortgages still account for more consumer complaints to the CFPB than any other area of consumer financial services—except debt collection. ¶ It is not surprising, then, that the CFPB's enforcement actions in 2015 continue to focus on mortgage-related practices. What is perhaps surprising is that recent enforcement actions are not confined to the nation's largest banks and non-bank institutions, but have expanded to smaller originators. ¶ This article provides an update on how the CFPB is modifying its definition

The Consumer Financial Protection Bureau has carved out special exemptions to its rules for small creditors. Yet it appears to have no carve-outs for small guys when it comes to enforcement. The bureau has cracked down equally hard on large and small players.

of "small creditor" for its mortgage-related rules and analyzes the substance and implications of recent enforcement actions against medium and smaller loan originators.

Are you a small creditor?

While many independent and community banks might characterize themselves as small, regional or local, the CFPB's current definition of a small creditor is narrow: a creditor that originates fewer than 500 first-lien residential mortgages per year, originates more than half of those mortgages in designated rural or underserved areas and has less than $2 billion in total assets. (See the CFPB's *Small Entity Compliance Guide,* p. 32, at http://files.consumerfinance.gov/f/201310_cfpb_atr-qm-small-entity_compliance-guide.pdf).

The CFPB proposes expanding the definition of small creditor to those: 1) originating, with affiliates, 2,000 or fewer first-lien residential mortgages, excluding loans that are retained in portfolio; and 2) holding, with affiliates, less than $2 billion in total assets.

The CFPB is amending its definition of small creditor to make sure that two adverse implications of this definition are addressed. The intent behind increasing the origination number from 500 to 2,000 mortgages and excluding from that count loans kept in the creditor's portfolio is to ease the definition's implied limitation on a smaller creditor's ability to provide credit to all qualified borrowers.

Also, the asset-size threshold encompassing affiliates is intended to prevent larger creditors from organizing their business structure in such a way as to take advantage of the mortgage rules intended for smaller entities.

Finally, the CFPB is amending its definition of rural within "rural or underserved communities" to include rural counties and all census blocks that are not designated urban. (The CFPB's list of rural and rural or underserved counties for 2015 is available at www.consumerfinance.gov/blog/final-list-of-rural-or-underserved-counties-for-use-in-2015.)

The CFPB's previous definition of rural county excluded all metropolitan statistical areas (MSAs) and adjacent micropolitan statistical areas, and was the subject of substantial criticism. (See, as an example, the Independent Bankers Association of Texas' "Comments on CFPB Amendments Relating to Small Creditors and Rural or Underserved Areas (Reg. Z)" submitted on March 30, 2015, at www.ibat.org/pdfs/2015/03/30/ibat-comments-on-cfpb-amendments-relating-to-small-creditors-and-rural-or.)

Lenders that may meet the criteria for small creditor under the amended definition should look at their data from the previous year to determine whether they are operating in a predominantly rural or underserved area. If a lender meets this criterion, then it may operate as a small creditor in this calendar year.

Lenders that have exceeded the loan origination or asset-size thresholds of a small creditor or that no longer operated in predominately rural or underserved areas within the preceding calendar year, may continue to operate as small creditors with respect to mortgage applications received before April 1, 2016.

The practical effect of being a small creditor

Three of the CFPB's major mortgage rules that went into effect in 2014 feature special provisions and exemptions for small creditors:

- Small creditors can still originate a Qualified Mortgage (QM) even with a high interest rate (up to 3.5 percentage points above the average prime offer rate) and can offer balloon payment mortgages for a period of two years;
- There is no debt-to-income (DTI) ratio limit for loans held in portfolio by the small creditor or sold to another small creditor within three years; and
- There is an exemption from having to establish escrow accounts for higher-priced mortgages.

As for the practical effect of being a small creditor, such lenders enjoy safe-harbor protection for a broader array of mortgage terms, but the status does not exempt them from compliance with many of the other mortgage rules that took effect in 2014.

Simply put, a lender's decision to stay in the mortgage business likely does not hinge entirely on whether it falls within the definition of small creditor.

Rather, a lender's ability to stay in the mortgage business depends on whether it can afford to update its computer systems and forms, and modify its business practices to comply with the various mortgage rules that came out in 2013 and went into effect in 2014 (see www.consumerfinance.gov/regulations/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z).

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UDAAP is the CFPB's Swiss Army knife

Before turning to the specific enforcement actions against smaller creditors, it is worth pointing out that in many of its investigations of mortgage creditors, large and small, the CFPB is looking for violations of UDAAP—a federal statute that prohibits any unfair, deceptive or abusive act or practice (UDAAP) in connection with a consumer financial services product or service.

Prior to the CFPB's UDAAP statute, the Federal Trade Commission (FTC) had its statute prohibiting any unfair or deceptive act or practice (UDAP). The only real difference between the two statutes is the political will and resources afforded to the federal agencies enforcing each. The CFPB came into being as a result of political will and public desire for stronger financial regulation, and therefore has been using the UDAAP statute much more frequently and aggressively than the FTC used its UDAP statute.

Both statutes have broad, vague language that allows regulators to use the statute to address myriad acts and practices they find problematic. From an institution's point of view, however, the vagueness and subjectivity of what constitutes unfair, deceptive or abusive behavior (i.e., it's in the "eyes of the beholder") makes it a challenge to identify potentially problematic behavior and correct it.

The CFPB indicates that guidance on what constitutes unfair, deceptive or abusive practices is available in several places—in its published consent orders, in its enforcement actions filed in federal court, in its examination manual and in guidance found in bulletins and other published statements. The CFPB's consent orders and agency enforcement actions filed in federal court are the only means of getting real-world examples of behavior that might trigger an enforcement response. This year has brought a number of enforcement actions against smaller creditors and servicers, and they are all in the context of how mortgage products were marketed to the public and implicate liability for managing vendors.

CFPB enforcement actions against smaller creditors

Enforcement actions based on direct-mail marketing

On Feb. 12, 2015, the CFPB announced enforcement actions against three mortgage lenders—Owings Mills, Maryland–based All Financial Services LLC; Lehi, Utah–based Flagship Financial Group LLC; and San Diego–based American Preferred Lending—because of their direct-mail marketing campaigns.

All three companies tried to make a selling point of government-guaranteed or government-insured mortgage loans, whether Federal Housing Administration (FHA)–insured Home Equity Conversion Mortgage (HECM), Department of Veterans Affairs (VA)–guaranteed or Department of Housing and Urban Development (HUD)–insured mortgages.

Flagship Financial and American Preferred Lending settled with the CFPB, and therefore only consent orders are available as guidance. All Financial Services, however, initially disputed the allegations in the CFPB's complaint before reaching settlement. The complaint and answer in federal district court, therefore, provide valuable lessons for mortgage lenders as well as a rare glimpse into how the CFPB's investigation and enforcement process plays out.

Mortgage lender All Financial Services originates conventional and reverse mortgages in Maryland, Pennsylvania, the District of Columbia and New Jersey. The company has a Better Business Bureau (BBB) rating of A+.

At issue are All Financial Services' HECM solicitations that were sent to consumers between November 2011 and December 2012. HECMs are reverse-mortgage products originated by private lenders but insured by the FHA.

All Financial Services used a marketing company to create its solicitations, and during a 13-month period, 428,000 mailers—four variations on a similar theme—were sent to consumers.

The envelopes for the direct-mail solicitation simulated the look of an official government notice by reflecting a symbol of an eagle with arrows. Various statements were included on the envelope that sounded official, such as "Home Saver—HECM Program Eligibility Notice," "Government Lending Division" and "Housing and Recovery Act of 2008 Eligibility Notice"—as well as describing the lender with the preface "Eligible Lender" and setting out a federal statute citation for tampering with the mail.

The envelopes also conveyed a sense of time limitation with statements such as "Important Document Enclosed" and "Open Immediately." Inside the envelope, the correspondence described how a reverse-mortgage loan worked, using a high-level, colloquial explanation of the terms that led to imprecise statements about how payments worked.

Anyone who has worked in direct-mail marketing (or has been on the receiving end of direct-mail solicitations—which is everyone) knows that only envelopes with catchy, eye-grabbing statements and that convey a sense of urgency have a chance of being opened by a consumer. Likewise, direct-mail solicitations need to be easy to read and understand.

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In this case, however, the CFPB asserted in its court complaint that the direct-mail solicitations: 1) misrepresented that the source of the advertisements was, or was affiliated with, a governmental entity; 2) misrepresented that the FHA-insured reverse-mortgage program was time-limited or had a deadline; and 3) falsely stated that no monthly payments are required "whatsoever" under a reverse mortgage "as long as you and your spouse live in the home," when in fact homeowners are required to pay taxes and insurance and because these reverse mortgages can come due upon the death of the last borrower, regardless of whether a non-borrowing spouse still lives in the home, as well as for failure to pay taxes and insurance.

In the All Financial Services case, the CFPB brought claims of deceptive practices under UDAAP as well as a violation of Regulation N, which prohibits misrepresentations in mortgage advertising.

In its response to the complaint, All Financial Services defended itself by asserting that the CFPB's claims were barred or attributable to acts of others over which the company had no control. The company also argued that the claims were time-barred; many of the alleged wrongs were corrected by the company before the investigation began; and many of these allegations were not part of the initial investigation and statement of alleged wrongs to be corrected.

Ultimately, the parties reached settlement within a few months of the CFPB filing suit in federal court.

Based on the allegations in the CFPB's complaint and the defenses raised by All Financial Services, there are a number of lessons for other creditors:

- First, All Financial Services had stopped the direct-mail solicitations at issue more than two years earlier—back in December 2012—and, according to its answer, had corrected many of the issues on its own before the CFPB's investigation. It is unknown what, if any, corrective steps All Financial Services actually took, but apparently the CFPB did not consider the corrective steps sufficient to avoid an enforcement action.

Based on experience in a civil investigation, it is possible that any efforts at self-correction were not well documented. Therefore, the first lesson for smaller organizations is that if statutory violations are suspected by the entity as part of its own self-monitoring, then an outside attorney should be retained to assist with the review and documentation. This provides attorney-client protection, and even if the results of the internal investigation are produced to the CFPB, the documentation will be in a useful format.

■ Second, one of All Financial Services' affirmative defenses is that the outside marketing company that prepared the materials is directly responsible for the content of the direct-mail solicitations. While it is unknown whether All Financial Services or its marketing company had the contractual responsibility to ensure compliance with all applicable laws, from the CFPB's point of view, the investigated entity is responsible for a service provider's actions.

In fact, the CFPB has signaled in other actions that legal responsibility for vendors' actions may lie with the investigated entity (see, for example, *In re U.S. Bank, National Association,* [Sept. 25, 2014], available at http://files.consumerfinance.gov/f/201409_cfpb_consent-order_us-bank.pdf). Therefore, smaller organizations need to designate an employee to review and monitor services provided by vendors—whether marketing, billing or debt collection.

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■ Third, from a substantive point of view, a lender's marketing materials should be reviewed to avoid the sort of language and visuals used in these marketing materials. The CFPB has gone after four entities for UDAAP violation in conjunction with marketing of government-guaranteed loans. (In addition to the three actions cited earlier, see also the consent order entered with RMK Financial Corporation, available at http://files.consumerfinance.gov/f/201504_cfpb_consent-order_rmk-financial-corporation.pdf.)

■ Fourth, the mortgage lender complained that the allegations that were made part of the enforcement action were not part of the CFPB's findings to the lender at the conclusion of the investigation. The implication here is that the CFPB's investigation process is more likely to ask for a lot of information, but not to be forthcoming with its findings during the course of the investigation. It is a heads-up that the investigation process is an opaque one.

Enforcement actions based on loan originator compensation

On June 5, 2015, the CFPB entered a consent order with San Francisco–based mortgage broker and lender Guarantee Mortgage Corporation, based on violation of the Loan Originator Compensation Rule. That rule is intended to protect consumers from being steered into costlier loans by prohibiting loan originators from receiving compensation based on the interest rates of the loans they close.

Guarantee Mortgage was an independently owned mortgage banking firm that operated 10 branches in the San Francisco Bay Area, and at the time of the settlement was dissolving. Nevertheless, it was forced to pay a civil penalty of $228,000, and because the company did not have assets to pay the penalty, the owners of the business had to be personally liable.

In the consent order, the parties stipulated that from April 2011 until August 2012, Guarantee Mortgage paid monthly fees to producing branch managers and some loan originators that were based on the profitability of the branch. Specifically, producing branch managers were partially funded by payments Guarantee Mortgage made to marketing services entities partially owned by the branch managers, and these branch managers and some loan originators drew a portion of those fees as compensation.

Under the company's agreements with its producing branch managers, the fees were not supposed to include income from loans originated by them. But as a result of Guarantee Mortgage's accounting methods, those fees did include income from originations of consumer retail loans. Consequently, Guarantee Mortgage's payment to its producing branch managers and some loan originators violated the Loan Originator Compensation Rule.

Based on the stipulated facts in the consent order, there are two lessons for smaller creditors:

■ First, compensation programs for loan originators are always being modified and adjusted to meet business objectives, but compensation programs need to be scrutinized to make sure that no aspect of compensation derives from the terms of the loans being originated.

In Guarantee Mortgage's case, it appears that the fact that branch manager income was partially tied to loan terms was not known and may have been opaque to the organization. Nevertheless, the organization was responsible. The CFPB reached settlement with larger entity RPM Mortgage Inc. regarding this same issue (see CFPB press release at www.consumerfinance.gov/newsroom/cfpb-orders-rpm-mortgage-to-pay-19-million-for-steering-consumers-into-costlier-mortgages).

■ Second, while the CFPB's civil penalties are based on the institution's financial capability (though how the CFPB makes that determination is unknown), if the institution is financially unable to satisfy the penalty, individual owners will be made liable. The same penalty on an individual owner was ordered in the RPM case.

CFPB is publishing full-text complaints from consumers

Finally, of great importance to both large and small creditors alike, the CFPB has started publishing on its website full-text consumer complaints that are searchable by institution and by category of complaint.

While the CFPB asserts there will be some "screening" of complaints before they are made public, it is certain that the published complaints will present only the customer's view of the facts surrounding any origination or servicing issue.

The database purportedly affords a financial institution an opportunity to respond publicly to the complaint, but the database merely permits a response via a few radio buttons. Also, as a practical matter, due to an entity's obligation to comply with federal and state-specific financial privacy rules, even if full-text responses were permitted by the database, an entity could not provide substantive information about the mortgage loan/account at issue.

The significance of the publicly available full-text complaints is twofold. First, plaintiffs' attorneys have a database at their disposal in crafting individual or class-action lawsuits against an entity. Second, the CFPB will be monitoring these consumer complaints for their substance as well as their frequency by institution in order to guide what investigations to conduct.

Therefore, smaller creditors and servicers will want to monitor publicly available complaints and make sure that their files reflect substantive responses and proper resolution if there is an issue.

In 2015, the CFPB is amending its rules regarding small creditors and is also investigating and enforcing mortgage rules against smaller institutions more than in previous years. For those institutions that have adapted and continue to adapt to the new mortgage environment, the CFPB's recent enforcement actions provide additional guidance on how to comply with the myriad rules. MB

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