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Mid-South Regulatory Compliance Group

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ATR/QM VS. TRID

In our recent Steering Committee meeting, several of the committee members agreed that there was considerable confusion among their banks' staff about the whole issue of Ability to Replay and Qualified Mortgages, as it relates to the upcoming implementation of the Truth in Lending/RESPA Integrated Disclosure (TRID) requirements that will go into effect October 3, 2015. And where do High-Cost Mortgages and Higher-Priced Mortgages fit in? The patchwork is confusing, so we agreed to take a shot at trying to make some sense of this jumble of regulatory requirements.

Where To Begin?
Perhaps An Overview Will Be Helpful.

The Truth In Lending Act (TILA) is the primary consumer protection statute for loan transactions. It contains different rules depending on whether a mortgage is open-end or closed-end, whether it is purchase money or not, and depending on the price of the loan. The greatest protections apply to the most expensive loans that are secured by a borrower's home. Purchase money loans have fewer protections than home equity or refinance loans. Open-end mortgages are excluded from many protections that apply to other mortgage loans.

This assortment of laws and regulations makes a little more sense if you view them as a response to two different crises: (1) the crisis in the early 1990s related to high-priced home equity lending, and (2) the failure in underwriting of mortgage loans that led to the subprime mortgage meltdown and its consequent foreclosure crisis some 10 – 15 years later. Needless to say, Congress and the regulatory agencies have taken a number of stabs at trying to address the root causes of these problems.

Hopefully it will make sense to you if we begin with the broadest category of loans (closed-end loans secured by a borrower's primary residence), then move to "higher-priced" (subprime) loans secured by a borrower's principal residence and conclude with "high-cost" (HOEPA) loans which are high cost and high risk, non-purchase money mortgages secured by a borrower's principal dwelling.

The Ability to Repay Rule

A creditor that makes a closed-end home-secured mortgage (excluding timeshares, bridge loans, and reverse mortgages) must make "a reasonable and good faith determination at or before loan closing that the borrower has a reasonable ability to repay the loan based on its terms."

Think of the Ability to Repay as a minimum set of standards. The reasonable and good faith determination required must be based on verified income, assets, and debt (including any simultaneous mortgages). The creditor must also consider either the borrower's debt-to-income ratio (including the mortgage applied for) taking into account all outstanding debts, taxes, insurance and simultaneous mortgages, or the borrower's residual income (subtracting all debt payments from income). The payment that the loan requires must be fully indexed and fully amortizing in terms of affordability and any balloon mortgage must be evaluated for repayment ability using the highest payment in the first five (5) years of the loan.

Under the ATR Rule, there is no set limit on the borrower's debt-to-income ratio or the amount of residual income that is needed. Still, the creditor must collect, verify and assess the borrower's ability to repay using all of this information. Taking into account all of this information, a creditor has leeway to set its own underwriting standards when simply meeting the general ability-to-repay requirements.

Qualified Mortgages

The adoption of the Ability to Repay Rule (ATR) raised serious questions about liability for violations of TILA. To help with those concerns, the CFPB created a category of safer loans referred to as Qualified Mortgages (QM's). Loans meeting the QM standards receive either a safe harbor or presumption of compliance with the ATR Rule, depending on the loan's level of pricing.

General QM

The basic definition of a QM includes the following elements:

- No negative amortization;
- No interest only loans;
- No balloon payments;
- Income and assets verified and documented;
- Underwriting based on fully amortizing payments over the entire term for fixed-rate loans;
- Underwriting for adjustable rate loans based on fully amortizing payments using the maximum applicable rate during the first 5 years of the loan after the date of the periodic payments;
- Consideration and verification at or before closing of current or reasonably expected income or assets and current debt obligations, alimony, child support, using reasonably reliable third party records;
- Total monthly debt-to-income ratio not exceeding 43% or, in the alternative, residual income must be considered;
- Total points and fees payable in connection with the loan not to exceed 3% of the total loan amount;
- Maximum term of 30 years; and
- Prepayment penalties not in excess of regulatory limitations.

The CFPB expanded on this definition by adding the following:

- Monthly debt obligations must be verified; and
- The total debt-to-income ratio must not exceed 43%.

In addition, there is a points and fees cap for all forms of Qualified Mortgages. The cap is higher for smaller loans with some limits expressed as dollars rather than percentages:

- Three percent (3%) of the total loan amount for a loan greater than or equal to $100,000;

- Three thousand dollars ($3,000) for a loan greater than or equal to $60,000, but less than $100,000;

- Five percent (5%) of the total loan amount for a loan greater than or equal to $20,000 but less than $60,000;

- One thousand dollars ($1,000) for a loan greater than or equal to $12,500 but less than $20,000;

- Eight percent (8%) of the total loan amount for a loan less than $12,500.

In addition to the General QM, there are three other types of QM that are available to certain creditors that either meet specific requirements or originate certain types of loans. These three types of QM are:

- The Temporary or GSE QM;

- The Small Creditor Portfolio QM;

- The Small Creditor Balloon Payment QM.

Temporary QM

Certain loans originated during a transitional period that are eligible for purchase by FNMA or FHLMC or are insured or guaranteed by certain federal agencies, can receive QM status. This transitional period expires when FNMA or FHLMC exit receivership or January 10, 2021, whichever comes first. Loans using an automated underwriting tool from one of these GSE's qualify.

Small Creditor QM's

A creditor is considered to be a "small creditor" if it has total assets of $2 billion (adjusted annually, so somewhat higher now) and if it originated 500 or fewer first lien covered loans during the prior year (this limit is proposed to be relaxed soon). There are two types of Small Creditor QM's potentially available: (1) the Small Creditor Portfolio QM and (2) the Small Creditor Balloon Payment QM.

Small Creditor Portfolio QM

This type of QM must meet the same product features and points and fees standards that apply to the General QM. However, there is no 43% debt-to-income ratio limit and the creditor must use the maximum interest rate in the first five years and an amortizing payment to determine the monthly payment amount. These loans must be held in the creditor's loan portfolio for at least three years.

Small Creditor Balloon QM

All small creditors can originate Small Creditor Balloon QM's for a time. As presently proposed, after April 1, 2016, small creditors will also have to satisfy a "rural or underserved" test (more than five percent of first-lien loans made during the preceding year must be in rural or underserved areas).

These Small Creditor Balloon QM's must satisfy General QM product features except for the prohibition on balloon payments and deferment of principal.

The loan must have:

- Scheduled payments that are substantially equal, using an amortization schedule that does not exceed 30 years;

- A fixed interest rate;

- A loan term of five years or longer;

- No interest-only loans or loans with adjustable rates.

And, of course, the loan must satisfy the Standard QM points and fees test. There is no

43% debt-to-income limit and the creditor must base its decision regarding repayment ability based on the borrower's actual debt-to-income ratio or residual income.

Both Small Creditor QM's use verification procedures similar to the General QM option and both types of Small Creditor QM loans must be held in portfolio.

Higher-Priced Mortgage Loans

Two additional classes of loans require more in the way of consumer protections. These are referred to as "higher-priced" mortgage loans (HPML's) and HOEPA loans. First let's consider the additional requirements for HPML's.

In 2008, the Federal Reserve Board issued regulations addressing "higher-priced" mortgage loans. The rule applied to loans with an APR above a certain threshold and prohibited four (4) acts or practices:

- Failure to evaluate a borrower's ability to repay;
- Inclusion of a prohibited prepayment penalty;
- Failure to establish an escrow account; and
- Structuring the loan as open-end credit to avoid or evade the requirements.

In 2013, the CFPB amended the HPML rules to implement provisions of the Dodd-Frank Act that apply to escrow accounts. The CFPB also implemented the Dodd-Frank appraisal rules by applying them to HPML's. (These two sets of rules are discussed in a separate article in this edition of the Quarterly Report).

The HPML rules apply to all closed-end mortgages, including purchase money mortgages secured by a borrower's principal dwelling.

A loan is an HPML if it is a first-lien loan secured by the borrower's principal dwelling and the APR exceeds the average prime offer rate (APOR) for a comparable transaction by 1.5% or more. A subordinate lien loan is an HPML if the APOR exceeds the APOR by 3.5% or more.

Once again, TILA imposes four (4) restrictions on HPML's:

- Ability to repay restrictions;
- Limits on prepayment penalties;
- Escrow requirements; and
- A prohibition on evading these requirements by structuring the loan as open-end credit.

A creditor that makes an HPML must now evaluate the borrower's ability to repay using the requirements of the ATR Rule relevant to the ability to repay.

After the January 10, 2014 rule changes, prepayment penalties became very restrictive. The HPML with a prepayment penalty of any amount will not meet the standards for a QM. Regardless, an HPML may not have a prepayment penalty that goes beyond 36 months from closing or assesses more than a two percent (2%) penalty on the amount prepaid. Any violation of these restrictions would trigger HOEPA loan provisions (discussed below) and simultaneously violate HOEPA.

HOEPA Loans

HOEPA stands for the Home Ownership Equity Protection Act and has been around in various forms since 1994. HOEPA was amended in a significant way in 2010 with the passage of the Dodd-Frank Act. The Dodd-Frank Act refers to these loans as "high-cost" loans.

Whether or not a loan is "high-cost" is determined by one or more of three (3) possible triggers being tripped. The three (3) triggers are: (1) the APR of the loan, (2) the total amount of points and fees charged, and (3) the timing and amount of any prepayment penalty that applies.

Originally, HOEPA only covered closed-end mortgages. The Dodd-Frank amendments extended HOEPA protections to open-end, purchase money and initial construction loans as well.

For HOEPA to apply, the loan must be consumer credit and must be secured by the borrower's principal dwelling.

Beginning in 2014, the HOEPA trigger became based on the average Prime Offer Rate which is the APR for loans in Freddie Mac's Primary Mortgage Market Survey. Under the revised triggers, a loan will be a HOEPA loan if the APR exceeds the APOR by more than 6.5% on first mortgages or 8.5% on subordinate liens or first mortgages under $50,000 secured by a dwelling classified as personal property.

The second trigger is the points and fees trigger and it contains two tests based on the loan amount. If the loan is $20,000 or more, the loan is a HOEPA loan if the points and fees exceed 5%. For loans under $20,000, the trigger is the lesser of 8% or $1,000. The $1,000 and $20,000 amounts are indexed for inflation.

The third trigger is the prepayment penalty discussed above. Thus, prepayment penalties are banned on loans that trigger HOEPA.

Most banks simply avoid making HOEPA or high-cost loans by pricing mortgages below the APR and points and fees triggers in order to avoid the onerous provisions and penalties that apply. Therefore, we will only provide a brief summary of these provisions and possible penalties.

The Dodd-Frank Act prohibits balloon payments on HOEPA loans, but the CFPB created an exception for small creditors operating in rural or underserved areas. To qualify, the loan must meet most of the standards of a QM. In addition, the creditor must determine that the borrower can make the required payments, must consider the borrower's debt-to-income ratio or residual income, and must verify the borrower's income and debt. The loan must be fixed-rate and at least five years in length with equal installment payments and a 30 year amortization. Until April 1, 2016, all small creditors have this option, regardless of whether they operate in rural or underserved markets.

Negative amortization is prohibited.

This summarizes the underwriting requirements, as well as the product limitations and prohibitions in place today for most traditional mortgage loan products, as well as mortgage loan products that meet the definition of either higher-priced or high-cost mortgages. But the CFPB was not through there. It has developed final regulations that deal with mortgage loan servicing requirements for various ones of these loans. (See the November 2013 *Quarterly Report* for a summary of these rules.)

TRID

But what about TRID, the CFPB's effort to combine the Truth in Lending mortgage loan disclosures with the RESPA disclosures related to mortgage loan originations? How does TRID relate to ATR, QM, higher-priced and high-cost mortgage loans? The truth is that TRID and ATR/QM, etc. are only linked in the marginal sense that they all relate to mortgage lending.

The purpose of TRID is to provide a mortgage loan applicant with information about the costs and terms of the loan he/she is applying for. It is meant to aid in shopping for the best and most appropriately affordable product available.

The TRID Rule applies to loans applied for after October 3, 2015. It covers most closed-end consumer mortgage loans and includes construction only loans and loans secured by vacant land or by 25 or more acres of land. It does not apply to:

- Home equity lines of credit;
- Reverse mortgages; or
- Loans secured by a mobile home or dwelling not attached to real property.

Prior to the Dodd-Frank Act, TILA was limited to disclosure of the cost of credit, and settlement charges disclosures were covered by RESPA.

However, Dodd-Frank expanded TILA to govern the disclosure of all charges imposed in connection with a mortgage loan including settlement costs previously disclosed under RESPA. The creditor now is solely liable for the accuracy of information provided in the new Closing Disclosure which combines information previously provided in the HUD-1 and final TILA disclosure statement.

Under the TRID Rule, four forms become two. A Loan Estimate form combines the initial TILA early disclosure form with the former RESPA Good Faith Estimate. The Closing Statement consolidates the former Final TILA Disclosure Statement and the RESPA HUD-1/1A Settlement Statement.

The TRID Rule contains detailed requirements related to the timing of disclosure, the changes that can occur once certain disclosures have been provided and responsibility for any errors or impermissible changes.

The ATR/QM and other rules are aimed at underwriting of loans in a manner that borrowers can afford and protecting borrowers from loan products with questionable terms and conditions. The TRID Rule is meant to protect borrowers by disclosing to them the cost of the settlement process once they have been approved for a loan and protecting them from unexpected changes leading up to closing. The two sets of rules complement each other, but only relate in the sense that they protect borrowers throughout the mortgage loan origination process.

There is considerable potential for liability under TILA as a result of each of these regulatory changes. Failure to satisfy the ATR Rule by simply underwriting loans according to the eight ATR underwriting criteria, or in the alternative, structuring a loan as a QM would result in a violation of TILA that could rise to class action proportions. Failure to follow the new settlement cost disclosure regimen under the TRID Rule will result in possible TILA violations as well with additional potential for liability. Previously settlement cost disclosure would have been covered by RESPA which did not provide for private rights of action. Now the potential exposure for banks has grown considerably.

(Ed Wilmesherr)

MORE ON MORTGAGE LOAN PROTECTIONS

Along with protections from abusive loan underwriting practices and unclear settlement services charges, the Dodd-Frank Act addressed two additional areas of concern for loans secured by a borrower's principal dwelling: (1) appraisal practices and (2) escrow account requirements. Somewhat like ATR/QM, these requirements are loosely tied to the pricing of the loan, with somewhat greater protections afforded to loans labeled "higher risk" in the Dodd-Frank Act; the CFPB uses the terminology "higher priced" that it has adopted for other regulatory protection purposes.

Appraisal Standards. Beginning in 2008, before the CFPB, the Federal Reserve Board developed appraisal independence rules. The Federal Reserve Board repealed those rules in favor of later rules it developed to implement appraisal independence standards contained in the Dodd-Frank Act. The CFPB has adopted those rules along with rules dealing with payoff statements and prompt crediting of payments.

The appraisal independence rules apply to all creditors that extend credit secured by a borrower's principal dwelling. These regulations prohibit "covered persons" from engaging in coercion when it comes to valuing a home. Regulation Z broadly states, "no person that prepares valuations shall materially misrepresent the value of the consumer's principal dwelling in an evaluation."

The regulation goes on to list a number of prohibited coercive activities:

- Seeking to influence an appraiser to provide a minimum or maximum appraisal value;
- Withholding or threatening to withhold payment unless an appraisal at or above a certain amount is provided;
- Implying that future engagements depend on appraisal values provided;
- Excluding appraisers that provide appraisals below predetermined levels from future consideration; and
- Tying appraiser compensation to the actual closing of the loan.

In addition, covered persons are prohibited from falsifying or altering appraisals. Inducing someone else to falsify or alter an appraisal is also prohibited.

As a creditor, you are prohibited from extending credit on the basis of an appraisal that materially misstates or misrepresents the value of a borrower's principal dwelling.

The various regulatory agencies have issued guidance detailing rules for obtaining appraisal services. Slightly different rules apply to creditors with assets in excess of $250,000,000 when it comes to in-house valuation services.

The Dodd-Frank Act prohibits creditors from making "high risk mortgages" without obtaining a written appraisal that meets certain requirements. When adopting the implementing regulations, the CFPB adopted the existing term "higher-priced mortgage loan" (HPML), rather than create a new category of mortgages.

The appraisal rule for HPML's requires creditors to use a licensed or certified appraiser to prepare a written appraisal based upon a physical inspection of the interior of the property. Creditors are also required to disclose to applicants information about the purpose of an appraisal and to provide applicants with a free copy of the appraisal. These rules became effective January 18, 2014.

A number of transactions are exempt from these requirements, including:

- Reverse Mortgages;
- Qualified Mortgages;
- Temporary Bridge Loans;
- Construction Loans; and
- Loans secured by mobile homes, boats and trailers.

The rule also exempts loans for amounts that do not exceed a certain threshold that adjusts annually. For 2015, that minimum loan amount is $25,500.

Another exemption exists for certain "streamlined refinance" transactions. These transactions must have the following features:

- Must refinance an existing first-lien;
- Credit risk must be retained by the same originating creditor with no agreement to transfer the risk;
- Must have regular payments that fully amortize the loan; and
- Loan proceeds can only be used to pay closing costs and payoff the existing loan.

For certain HPML's, a creditor must obtain a second appraisal. If the seller of the piece of property acquired that property at a lower price during the previous six months and the price exceeds certain thresholds, a second appraisal will be required at no cost to the borrower.

Appraisal rules now rank as a serious compliance topic post Dodd-Frank.

Mandatory Escrow Accounts. New rules apply for escrow accounts on HPML's. Unless an exemption exists, an escrow account must be established for a first-lien HPML for payment of (1) property taxes and (2) premiums for mortgage-related insurance required by the creditors. Premiums for mortgage-related insurance not required by the creditor, e.g., earthquake insurance, need not be escrowed. This requirement does not affect the ability of a creditor to offer or require an escrow account according to the terms of any loan contract with the borrower.

No escrow account is required for:

- A loan secured by shares in a cooperative;
- A loan to finance initial construction;
- A temporary or bridge loan; or
- A reverse mortgage.

An additional exemption applies for certain small creditors that operate predominately in rural or underserved markets. To qualify for this exemption, the creditor must satisfy four conditions:

- In any of the three preceding calendar years, the creditor must have originated more than 50% of its first-lien, covered transactions on properties located in either rural or underserved counties;
- During the preceding calendar year, the creditor cannot have originated more than 500 first-lien transactions covered by the ATR/QM rule;
- The creditor must not maintain an escrow account of the type required by the Rule for any other consumer credit secured by real property or a dwelling;
- The first-lien HPML must not be subject to a commitment to be acquired by a purchaser that does not qualify for the exemption.

Subject to certain qualifications, a creditor may only cancel a mandatory escrow account upon the earlier of:

- Payment of the debt secured; or
- Receipt no sooner than five years after closing of the borrower's request to cancel the escrow account.

Even in cases where a borrower makes the request to cancel after five years, the creditor is only permitted to cancel provided.

- The unpaid principal balance is less than 80% of the original value; and
- The borrower is not delinquent or in default.

These two additional mortgage protections, along with the new servicing rules round out the CFPB's ATR/QM/TRID approach to protecting borrowers through the mortgage loan application, approval and loan closing process.

(Ed Wilmesherr)

SCOTUS RULES ON DISPARATE-IMPACT – WHAT'S THE COMPLIANCE IMPACT?

On June 25, 2015, the U.S. Supreme Court announced its decision in *Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc.* In that case, the Inclusive Communities Project, Inc., a non-profit corporation that assists low-income families in obtaining affordable housing, challenged the Texas Dept. of Housing and Community Affairs' allocation of low-income housing tax credits and asserted a disparate-impact claim under the Fair Housing Act (FHA) alleging that the state agency had caused continued segregated housing patterns by allocating too many tax credits to housing in predominately black inner-city areas and too few to predominantly white suburban neighborhoods, and plaintiffs relied on statistical evidence to prove its claim. In a 5-4 decision, the Court ruled that disparate-impact claims may be brought under two sections of the Fair Housing Act (FHA) dealing with housing and lending. The Court's majority based its decision on its interpretation of the statutory language of the FHA and the premise that Congress had indicated its acceptance and approval of FHA disparate-impact claims when it amended the FHA in 1988 (at a time when all of the federal Courts of Appeals ruling on the issue up to that point had approved FHA disparate-impact claims) and did not expressly over-ride those decisions.

The Court did, however, emphasize that a mere statistical disparity was not enough to prove illegal discrimination based on disparate impact. To prevent abusive disparate-impact claims, the Court held that a three-step process must be rigorously applied by the courts and government agencies. The first step in the process is that the party bringing the action must first satisfy a "robust causality requirement" by showing that a specific policy caused the statistical disparity. Otherwise, defendants may be held liable for racial disparities they did not create. According to the Court, "[A] disparate-impact claim that relies on a statistical disparity must fail if the plaintiff cannot point to a defendant's policy or policies causing that disparity." A robust causality requirement is important in ensuring that defendants do not resort to the use of racial quotas.

The second step of the process involves shifting the burden of proof to the defendant to show a business justification for the policy or practice in question. The Court further explained that "[g]overnmental or private policies are not contrary to the disparate-impact requirement unless they are artificial, arbitrary, and unnecessary barriers." The Court stated that this is critical to ensure that defendants are not "prevented from achieving legitimate objectives."

Finally, under the third step, the burden of proof shifts back to the plaintiff. The Court emphasized that before rejecting a "business justification," a court "must determine that a plaintiff has shown that there is an available alternative practice that has less disparate impact and serves the entity's legitimate needs." The Court clarified that the plaintiff bears this burden of showing a less discriminatory alternative in the third step of the analysis, overruling some lower court decisions holding that the defendant had to prove there were no less discriminatory alternatives.

Without a rigorous application of this analysis and shifting of the burden of proof, the Court said that disparate-impact liability could be used to replace nondiscriminatory private choice: "Were standards for proceeding with disparate-impact suits not to incorporate at least the safeguards discussed here, then disparate-impact liability might displace valid governmental and private priorities, rather than solely removing artificial, arbitrary, and unnecessary barriers. And that, in turn, would set our Nation back in its quest to reduce the salience of race in our social and economic system."

So, what does the decision mean for financial institutions and fair lending compliance efforts? What should a bank do in response? Here are some basic things to think about.

One, disparate-impact claims are here to stay. While the decision in *Inclusive Communities* is limited to the FHA, and some legal experts are arguing that the language of the Equal Credit Opportunity Act is different and that disparate-impact claims are not cognizable under the ECOA, lenders should assume from a compliance standpoint that disparate-impact claims will continue to be brought under both the ECOA and the FHA. There is no doubt that the CFPB and the bank regulators will continue to use disparate impact as an enforcement tool.

Two, know your numbers. The federal bank regulators, the CFPB, and the Department of Justice (DOJ) will continue to rely on statistical analysis in exams and enforcement actions to prove discrimination. With a final rule on expanded HMDA reporting expected from the CFPB any day (and HMDA-like reporting for small business loans not too far off on the horizon), the regulators will soon have a significant amount of additional data readily available. Expect the regulators to routinely analyze that data and look for issues and outlier institutions to focus their attention on, just as they did after 2004 when rate spreads first began to be reported on HMDA LARs. It will be more important than ever for lending institutions to "know their numbers", *i.e.* know what is in their loan data before it is reported, understand the significance of those numbers, and be prepared to explain them or take steps to change them going forward, if need be.

Three, limit discretion in underwriting and pricing of loans. The decision in *Inclusive Communities* clearly states that mere statistical disparity is not enough. For a disparate-impact claim, there must also be proof that a specific policy or practice caused the disparity. While that is helpful, it will not always be a difficult burden for the regulators to meet. The regulators will likely try to establish causation in a broad, general way. Consider, for example, the Consent Order in the recent settlement between the CFPB, DOJ, and American Honda Finance Corp. (discussed elsewhere in this newsletter). The government said that its statistical analysis showed a disparity in indirect auto loan pricing for minority borrowers and that the disparity was caused by the lender allowing dealer discretion in setting a dealer markup over the lender's buy rate and compensating the dealers from the increased interest revenue without monitoring and employing adequate controls to prevent discrimination. Once basic causation is established, the burden then shifts to the lender to show a business justification for the practice. By limiting discretion and making sure that underwriting and pricing are based on objective, uniformly applied factors tied to credit risk and loan profitability, a lender should be able to clearly establish business justification (and possibly avoid any statistical disparity to begin with).

Four, remember that disparate impact is not just a concern for big banks and large consumer and mortgage lenders. Remember Nixon State Bank? Nixon was an $80 million bank that entered into a settlement agreement with DOJ in 2011 and agreed to pay about $100,000 in restitution and penalties in response to allegations that it priced loans to Hispanic borrowers higher than loans to non-Hispanic borrowers. The bank had made almost $8,000,000 in small dollar unsecured loans under $500 (as the regulators had encouraged banks to do). The highest interest rate was 10%, but using statistical analysis and a disparate-impact theory of discrimination, the DOJ was able to bring Nixon to the settlement table. The expense of litigating with the DOJ was just too great. While a sample of loans and/or loan applications needs to be large enough to lend itself to a sound statistical analysis, a community bank cannot take comfort in its size alone. And larger banks and lenders should be aware that a large sample of loans in an analysis oftentimes means that even small disparities become "statistically significant." BTW, Nixon State Bank later sold itself to one of its competitors.

(Cliff Harrison)

HONDA SETTLES DISPARATE-IMPACT CLAIM FOR $24 MILLION

On July 14, the CFPB and the DOJ announced a Consent Order with American Honda Finance Corporation, a captive auto finance company sub of American Honda Motor Co., Inc. and the 9th largest auto lender in the U.S., providing for payment of $24 million to resolve allegations that Honda charged higher interest rates to minority borrowers as compared to white borrowers with similar credit qualifications. In the order, the government asserted that Honda allowed its dealers to exercise discretion in setting the amount of the "dealer markup" on auto loan contracts which resulted in discriminatory pricing.

Honda set the "buy rate" at which it would purchase retail installment contracts and allowed its dealers to markup that rate by up to 225 basis points for contracts of 60 months or less and up to 200 basis points for contracts longer than 60 months. Dealers were paid additional compensation from the markup. Except for the overall cap, the amount of the markup was within the dealer's discretion and was not based on any objective credit risk factors.

The government's claim was based on disparate-impact. The CFPB and DOJ conducted a statistical analysis focused strictly on the amount of the dealer markup. No issue was raised with respect to how Honda set its buy rate. Since the retail contracts did not contain information on the race or national origin of the borrowers, the Bureau and DOJ assigned race and national origin to the borrowers using a proxy methodology that combines geography-based and name-based probabilities based on US Census Bureau data. The analysis found that, on average, African-American borrowers paid about 36 basis points or $250 more than non-Hispanic white borrowers. For Hispanic borrowers the average was 28 basis points or $200 more, and for Asian and/or Pacific Islander borrowers, the average was 25 basis points or $150 more.

The government claimed that the disparity was cause by Honda's practice of allowing dealers to mark up the contract rate above its buy rate and then compensating dealers from that increased revenue without establishing adequate controls and monitoring to prevent discrimination. Further, the government claimed that Honda's practice could not be justified by legitimate business need.

Under terms of the settlement, Honda agreed to pay $24 million in restitution to affected borrowers and to implement a new dealer compensation policy using any of three different options, subject to approval by the CFPB and DOJ. Honda can use different options for different dealers, but all contracts purchased from a particular dealer will have to be handled using the same option.

There are several takeaways from this settlement and consent order for any lender engaged in indirect lending through the purchase of retail installment contracts of any type. One is that the regulators will continue to use statistical analyses and disparate-impact claims in fair lending enforcement. Another is that lenders who participate in the initial credit decision and allow dealers to set or adjust the pricing will be held accountable for any discrimination that results from the dealer pricing. A third is that lenders may want to take a look at the dealer compensation options available to Honda which are outlined in the order for guidance in managing dealer markups and fair lending compliance in their own indirect lending program.

Under the order, the first dealer compensation option available to Honda would require that dealer discretion in setting the markup be capped at 125 basis points for terms of 60 months or less and 100 basis points for terms longer than 60 months. The lender could also pay the dealer an additional, non-discriminatory form of compensation. The order did not specify, but presumably that might take the form of a fixed fee or pre-set percentage markup or commission rate for each contract. The lender would be obligated to periodically remind dealers of their fair lending compliance obligations, including the obligation to price contracts in a non-discriminatory fashion, and the lender would have to periodically monitor for compliance with the markup caps.

Under the second option, the lender would establish a standard, pre-set markup or dealer participation rate for all contracts of no greater than 125 basis points for terms of 60 months or less and 100 basis points for terms longer than 60 months. The lender could also pay the dealer an additional, non-discriminatory form of compensation. Dealers would only be allowed to lower, not raise, the standard participation rate based on written policies and procedures that define specific, non-discriminatory exceptions for lowering the rate. The lender would require the dealer to maintain documentation supporting the reason for the exception, and the lender would be required to develop a compliance management system to monitor compliance that included training dealers on the lender's exceptions policies and procedures, regular monitoring of dealer exceptions and documentation of those exceptions, periodic audits of dealers for compliance, and corrective action for dealer non-compliance which might include eliminating the dealer's ability to lower the markup or ending the financing arrangement altogether.

Option three would be to completely eliminate the dealer's ability to adjust the rate. The order doesn't say, but, presumably, dealers would be paid a pre-set rate or amount for each contract that the dealer could not vary. The lender would be required to maintain a general fair lending compliance management system that includes regular notices to its dealers stating the lender's expectations for fair lending compliance and non-discriminatory pricing, but the lender would not have to monitor for disparities in dealer markup because the dealer would have no ability to adjust the rate.

It is also worthwhile to mention that the Bureau did not impose a civil money penalty on Honda because of its responsible conduct in cooperating with the investigation and remedying the problem.

(Cliff Harrison)

STANDARDS FOR ASSESSING DIVERSITY POLICIES AND PRACTICES FINALIZED

The Dodd-Frank Act contains a number of provisions that go beyond consumer protection and regulation of banking activities. One of those is found in Section 342 of the Dodd-Frank Act. That section requires each of the Federal bank regulatory agencies to establish an Office of Minority and Women Inclusion, sometimes referred to as the "OMWI Office." Each of those offices has a Director and is responsible for all matters related to diversity in management, employment and business activities of regulated financial institutions. Section 342 also directs each agency to develop a set of standards for assessing the diversity practices and policies of the financial institutions regulated by that agency.

In October, 2013, the CFPB, OCC, Fed, FDIC, NCUA and SEC issued for comment a set of jointly proposed standards for addressing the Section 342 requirements, in hopes of promoting a consistent approach for all of the financial institutions that they regulate. The comment period ended in February of 2014 and on June 9, 2015, the agencies issued final Standards in an Interagency Policy Statement (the "Joint Statement").

The Standards are intended to provide a basic framework for an entity to create and strengthen its diversity and inclusion policies and practices. The term "diversity" is defined to refer to minorities and women, although banks are free to use a broader definition, and "inclusion" means creating and maintaining a positive work environment that values individual similarities and differences. So, what do the Standards call for and how can a bank comply?

Five Parts. The Standards are divided into five parts or areas:

- Organizational commitment to diversity and inclusion;
- Workforce profile and employment practices;
- Procurement and business practices;
- Transparency of organizational diversity and inclusion; and
- Assessment.

Let's look at each part.

Organizational Commitment. This aspect looks at how a bank's leadership promotes diversity and inclusion in both hiring and contracting practices and how it fosters a corporate culture that embraces both diversity and inclusion (in this article, we will just use "diversity" to refer generally to both diversity and inclusion). A bank meets the Standards if it:

- Makes diversity in employment and contracting a part of its strategic plan for recruiting, hiring, retention and promotion;
- Has a diversity policy approved by the board and senior management;
- Provides regular progress reports to management and the board;
- Conducts training on equal employment opportunity and diversity;
- Designates a senior level official who oversees and directs the bank's diversity efforts;
- Is proactive in recruiting, hiring and promoting within a diverse group of women and minorities, as well as in its selection of board members, senior management and other leadership positions.

Workforce Profile and Employment Practices. This part looks at the demographics of the bank's workforce and the employment practices it uses to promote fair inclusion of women and minorities, such as publicizing job opportunities, creating relationships with minority and women's organizations and including success in meeting diversity goals as an element of evaluating the performance of management. An entity meets the Standards if it:

- Ensures equal employment opportunities for all applicants and employees and complies with applicable laws;
- Has hiring and promotion policies and practices that create a diverse pool of applicants for internal and external employment opportunities, which may include reaching out to minority and women's organizations, working with educational institutions, and participating in conferences, workshops, etc. to attract diverse applicants;
- Uses both quantitative and qualitative measurements to assess its diversity efforts; and

- Holds management at all levels accountable for diversity efforts.

The Standards mention using metrics to track the effectiveness of a bank's diversity program. Certain financial institutions have been subject to reporting requirements regarding diversity hiring practices and results for years. In particular, banks with 100 or more employees and banks who are federal contractors (including banks that serve as a depository for U.S Government funds in any amount, or banks that are issuing agent or paying agent for U.S. Savings Bonds and Notes) and employ 50 or more employees are required to file Employer Information Report EEOC-1 with the Equal Employment Opportunity Commission (EEOC) and the Office of Federal Contract Compliance Programs (OFCCP). The Standards do not expand on this mandatory reporting requirement. If your bank is not already required to file the EEOC-1 Report form, you will not be required to do so under the Standards. However, the Standards encourage banks and other regulated entities that are not required to file EEOC-1 Reports to monitor and assess their diversity policies and practices. Smaller entities may need to focus more on qualitative measurements, such as by tracking outreach efforts, rather than on quantitative tracking of their workforce race, ethnicity and gender.

<u>Procurement and Business Practices</u>. This area looks at how a bank makes diversity a part of its process in selecting vendors and suppliers. The Joint Statement seems to acknowledge that this area may be one that proves difficult. Banks, particularly smaller banks, may find it difficult to gather and track information on the diversity practices and successes of the vendors, suppliers, and others they use for support services. A bank meets the Standards if it:

- Has a supplier diversity policy that provides a fair opportunity for minority and women-owned businesses to compete for the entity's business;
- Has methods for evaluating its supplier diversity which might include metrics tracking annual procurement spending and the proportion spent with minority and women-owned contractors by race, ethnicity and gender; and
- Has practices to attract a diverse supplier pool, which might include outreach efforts, participation in conferences and workshops and publicizing its procurement opportunities.

<u>Practices to Promote Transparency</u>. Transparency involves making information about the bank's efforts to achieve diversity available to the public, as well as to those potential employees, suppliers, etc. that might see an opportunity. An entity is transparent with respect to diversity if it publicizes information about its diversity efforts through normal business methods such as use of its website, development of promotional materials, and inclusion of diversity goals and successes in annual reports to shareholders, if applicable. Among the items of information mentioned in the Standards which might be made available to the public are:

- The bank's strategic plan for achieving diversity and inclusion;
- A written commitment to diversity and inclusion;
- The entity's progress toward achieving its diversity goals, which might include demographic profiles for the bank's current workforce and suppliers; and
- A statement of current employment and procurement opportunities, forecasts for potential employment and procurement opportunities and the availability of any mentoring or development programs for employees and contractors.

<u>Assessment</u>. The Standards make it clear that the term "assessment" means self-assessment where the bank, and not its regulator, looks candidly at its past, present and anticipated

future efforts to achieve diversity. A bank meets the Standards if it:

- Conducts an annual self-assessment following the Standards;
- Monitors and evaluates its performance on an ongoing basis;
- Provides information on its self-assessment to its primary federal regulator; and
- Publishes information pertaining to its diversity efforts.

The good news is that the Joint Statement says specifically that diversity will not become the subject of examination procedures. Language taken from the Dodd-Frank Act states that nothing in the Joint Statement "may be construed to mandate any requirement (that may) affect the lending policies and practices of any regulated entity, or to require any specific action based on the finding of (an) assessment." Also, the Joint Statement makes frequent reference to the particular circumstances of each individual bank. When drafting the Standards, the agencies focused on entities with more than 100 employees. While all entities are encouraged to follow the Standards, the Joint Statement recognizes that issues such as size, resources, location, demographics, etc. should be taken into account when reviewing a bank's efforts and successes in achieving diversity.

While compliance with the Standards is voluntary, it is important to remember that each agency now has a Director for its Office of Minority and Women Inclusion. It only logical to assume that sooner, rather than later, these Directors will begin to look at whether and how the institutions they regulate perform their assessments. To the extent practicable, it would be wise for any bank to consider the Standards and to make an effort to collect and provide, or at least have available, the type of information the Joint Statement outlines.

(Cliff Harrison)

FLOOD CHANGES AND CLARIFICATIONS

Five federal financial agencies recently issued a final rule related to loans secured by a dwelling or mobile home located in a special flood hazard area ("designated loans"). The rule implements changes and clarifications related to requirements for escrowing flood insurance payments, mandatory purchase requirements for certain detached structures, and force placement. The final rule also includes two sample notices- the revised Notice of Special Flood Hazards and Availability of Federal Disaster Relief Assistance and the new Sample Clause for Option to Escrow for Outstanding Loans.

<u>Escrow</u>

Beginning on January 1, 2016, lenders will be required to escrow premiums and fees for flood insurance when a designated loan is made, increased, renewed or extended unless an exception applies.

Lenders will also be required to offer the option of escrow for flood insurance premiums and fees to non-exempt loans outstanding as of January 1, 2016. This offer must be made by June 30, 2016 and a lender who loses an exemption must provide the option to escrow notice by September 30 of the calendar year during which the exempt status changes. If the borrower requests escrow, then the escrow must begin "as soon as reasonably practicable."

There are several exemptions to the escrow requirement. The first is a small lender exemption for lenders who meet the following criteria: (1) had total assets of less than $1 billion as of December 31 in either or both of the two previous years; (2) was not required to escrow taxes and insurance for the term of the loan on July 6, 2012; (3) and, also as of that time, did not have a policy of escrowing taxes and insurance.

The following types of loans are also exempt from the escrow requirements: (1) subordinate loans secured by the same property on which flood insurance meeting the mandatory purchase requirement has already been obtained; (2) designated loans that are part of a condominium, cooperative, or other project development if the group policy meets the mandatory purchase requirement; (3) loans secured by covered property but made primarily for business, commercial or agricultural uses; (4) HELOCs; (5) loans that are 90 or more days past due; and (6) loans with terms less than 12 months.

Lenders who were previously exempt, but become covered by the escrow rule after January 1, 2016, should begin escrowing for designated loans on July 1 of the calendar year during which the exempt status changed.

Detached Structures

Beginning on October 1, 2015, flood insurance is not required for a structure located on a residential property if it is detached from the primary residence and is not used as a residence. A residential property is one that is used for personal, family or household purposes. A structure is detached if it stands alone from the residential structure without a structural connection. The determination of whether or not a detached structure serves as a residence is to be made on a case-by-case basis by the lender. Detached structures that are not part of residential property but secured loans used for business purposes are not exempt from insurance coverage because such structures provide value to the bank and to the borrower. However, if a business purpose loan is secured by a residence, then the exemption does apply and coverage is not required.

The detached structure exemption was put into place because the cost of insurance for these types of detached properties is usually significantly greater than the benefit of having the insurance to the borrower.

Determination of detached structure status should be made when a designated loan is made, increased, renewed or extended. If a detached structure loses its detached status, then the lender must notify the borrower that insurance is required and if insurance is not purchased within 45 days, it must be force-placed.

Force-Placed Insurance

The agencies also clarified force-placement requirements. If a designated loan is not covered by a sufficient amount of flood insurance, then the lender must send notice to the borrower, and if the proper coverage is not obtained within 45 days, then the lender is permitted to force- place coverage and charge the customer beginning on the date on which the borrower's coverage became insufficient. This date is the expiration date on the policy, or the date that the insurance was cancelled.

If the borrower obtains flood insurance that overlaps with the lender's policy, then the lender must refund any premiums paid by the borrower during the timeframe that the policies overlapped. The lender may force-place coverage at any time during the 45 day period, but it must be placed before the end of the 45 day time frame.

Upon receipt of confirmation from the borrower or the insurer or its agent that the borrower has obtained proper flood insurance, the lender must cancel the force-placed policy within 30 days. Confirmation of the flood insurance is made by providing the declarations page of the insurance policy to the lender. The declarations page must include the existing policy number and contact information for the insurance company or its agent.

Compliance with the force-placement clarifications is effective on October 1, 2015.

(Memrie Fortenberry)

EXTENSION OF TRID EFFECTIVE DATE

On July 21, 2015, the CFPB finalized its proposal to extend the effective date of the TILA-RESPA Integrated Disclosure rules from August 1, 2015, to October 3, 2015. The goal of this extension is to allow banks extra time to prepare employees and loan systems for implementation. Further, the CFPB will keep the effective date on a Saturday in order to allow for an easier transition to new systems and system testing over the weekend.

(Memrie Fortenberry)

MRCG MEETING TO BE HELD ON AUGUST 20, 2015

The MRCG will hold its August Meeting on August 20, 2015, at the Mississippi Sports Hall of Fame & Museum Conference Center, 1152 Lakeland Drive, Jackson, Mississippi. Registration will begin at 9:00 a.m. with the meeting to begin at 9:30 a.m..

During the August Quarterly Meeting we will host a panel of compliance officers who are deep into the intricacies of implementing the new TRID disclosure policies and procedures that take effect October 3, 2015. We will also focus on the impact of the recent U.S. Supreme Court ruling that upheld HUD's use of disparate impact as a form of discrimination under the Fair Housing Act. We will also review the recent CFPB enforcement action against American Honda Finance Corp. which involved the issue of disparate impact in discretionary pricing. There will also be a discussion of recent developments in flood insurance regulations and the newly finalized standards for assessing a bank's diversity policies and practices.

As always, the dress code for this occasion is casual, and lunch will be provided. We ask that you fax or e-mail your registration to Liz Crabtree no later than Friday, August 14, 2015, so that arrangements for lunch can be finalized. We look forward to seeing you there.

(Ed Wilmesherr)

MSRCG MEETING TO BE HELD ON AUGUST 25, 2015

The MSRCG will hold its August Meeting on August 25, 2015, at The Racquet Club of Memphis in the Large Ballroom located at 5111 Sanderlin Avenue, Memphis, Tennessee. Registration will begin at 9:00 a.m. with the meeting to begin at 9:30 a.m.

During the August Quarterly Meeting we will host a panel of compliance officers who are deep into the intricacies of implementing the new TRID disclosure policies and procedures that take effect October 3, 2015. We will also focus on the impact of the recent U.S. Supreme Court ruling that upheld HUD's use of disparate impact as a form of discrimination under the Fair Housing Act. We will also review the recent CFPB enforcement action against American Honda Finance Corp. which involved the issue of disparate impact in discretionary pricing. There will also be a discussion of recent developments in flood insurance regulations and the newly finalized standards for assessing a bank's diversity policies and practices.

As always, the dress code for this occasion is casual, and lunch will be provided. We ask that you fax or e-mail your registration to Liz Crabtree no later than Thursday, August 20, 2015, so that arrangements for lunch can be finalized. We look forward to seeing you there.

(Ed Wilmesherr)

MRCG-MSRCG COMPLIANCE CALENDAR

10/28/14 - Reg. P amendment allowing website posting of annual privacy notice effective	05/21/15 – MRCG Quarterly Meeting
10/29/14 – Comment period for proposed HMDA rule ends	07/16/15 – MRCG/MSRCG Joint Steering Committee Meeting
11/03/14 - Amendment to 2014 mortgage rules providing for ATR/QM points and fees cure effective	08/01/15 – Mandatory use of revised TILA/RESPA disclosure takes effect
12/29/14 - Comment period for proposed flood insurance escrow rule ends	08/20/15 – MRCG Quarterly Meeting
02/24/15 – MSRCG Quarterly Meeting	08/25/15 – MSRCG Quarterly Meeting
03/09/15 – Comment period for CFPB proposal on "safe" deposit products for college students ends	09/17/15 – MRCG/MSRCG Joint Steering Committee Meeting
03/16/15 – Comment period for CFPB proposed changes to mortgage servicing rules end	10/03/15 – Effective Date for TRID Regulations
03/23/15 – Comment period for CFPB proposed rules on pre-paid card disclosures ends	11/17/15 – MSRCG Annual Meeting
05/19/15 – MSRCG Quarterly Meeting	11/19/15 – MRCG Annual Meeting