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## Subprime Lending Lessons from the Ameriquest Settlement

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As has been widely reported, early last year Ameriquest Mortgage Company and related companies settled a multi-state investigation over certain allegedly deceptive consumer lending practices. The settlement included \$295 million to repay borrowers with loans originated between January 1, 1999 and December 31, 2005, plus \$30 million to pay for the investigations.<sup>1</sup>

Like Household Finance Corporation's nearly \$500 million settlement with the states in 2002, and to a lesser extent Citigroup's \$215 million and \$70 million settlements with the Federal Trade Commission and the Federal Reserve Board (which did not explicitly require as many changes to Citi's lending practices), the Ameriquest settlement represents another mile marker in an emerging "best practices" road map for subprime consumer mortgage lending. As such, lenders are well advised to compare the terms of this settlement to their current practices. The purpose of this article is to highlight certain terms of the settlement and suggest issues that lenders may wish to consider with respect to their own consumer mortgage lending programs. Keep in mind, however, that no new requirement imposed on Ameriquest is required of any other lender (at least not yet).

### ORAL DISCLOSURES

The settlement requires a number of oral disclosures for "Non-Prime loans" (defined as first lien loans where the APR is equal to or greater than two and a half percentage points above the yield for a treasury security of comparable maturity and, for junior lien loans, five percentage points

above the comparable treasury security yield). The oral disclosures, which are in addition to already existing Truth-in-Lending Act (TILA), Real Estate Settlement Procedures Act (RESPA), and other mandated written disclosures, cover the key loan terms, such as the repayment term, interest rate, monthly payment, existence of a prepayment penalty, whether amounts are escrowed, amount and effect of any discount points, and adjustable rate disclosures for adjustable rate mortgages (ARMs). If the application is not submitted orally, the substance of the oral disclosures must be provided in writing within three days of receiving the application.

Significantly, instead of imposing general requirements, the settlement agreement provides scripted language for these disclosures, which Ameriquest must use, or alternative language that is substantially similar. Over the years, lenders have had different views on the utility of scripted oral disclosures. While some have found them to be impractical or too restrictive to the sales process, other lenders have seen the value in oral scripts (especially when coupled with listening programs) in helping to ensure consistency in the sales process, as well as in reducing the risk of deceptive sales claims.

In addition to the specific scripted oral disclosures, the settlement agreement contains a number of negative covenants that prohibit Ameriquest employees from making potentially misleading statements. For instance, Ameriquest cannot represent that its interest rate or terms are "better," "lower" than, or "competitive" with those of other lenders, unless the representations are, in

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fact, true. The Household settlement also contained a number of provisions prohibiting Household from making misleading representations.

These are obviously prudent policies for lenders to have in place. While scripts can be very helpful in protecting a lender from claims of misrepresentation, it is also important that loan officers and others understand that statements should not be made which contradict, undermine or obscure the more specific disclosures.

### WRITTEN DISCLOSURE OF LOAN TERMS

The settlement also requires Ameriquest to provide consumers with a single page disclosure of the key loan terms within three days after obtaining loan pricing information (but in no event later than three days after when an appraisal or loan documents have been ordered). This requirement applies to all loans, and not just non-prime loans. The form of written disclosure contains information similar to that which Ameriquest is required to provide in the oral disclosures for non-prime loans. Household was also required by the regulators to implement a one page summary of key loan terms.

A clear, concise, written disclosure of key loan terms is another tool that can help protect lenders from deceptive sales claims. Disclosures required by RESPA and TILA have been in effect for many years now, but are often insufficient to protect a lender from misrepresentation claims even when properly given. In fact, there is a wide consensus among both lenders and consumer advocates that the current federal disclosures are unnecessarily confusing to consumers. Of course, any lender considering a simplified summary disclosure must ensure that it is consistent with the disclosures required by state and federal law.

### REDISCLASURE

Another key component of the settlement is a requirement to give a new written summary disclosure if there is a "material change" in the loan terms. The new disclosure must be mailed no less than six days before closing or otherwise delivered or made available to the consumer at least three days before closing for a non-prime refinance loan or one day before closing for all other loans.

A change is "material" if there is an increase in the interest rate of 30 basis points or more, or any increase in discount points other than as a result of the trading of discount points for an interest rate reduction that is affirmatively requested by the borrower; any increase in the repayment term of the loan;

a decrease in the loan amount greater than one percent; the addition of a prepayment penalty; or a change from a fixed rate to an adjustable rate loan.

The concept of redisclosure is currently the subject of much discussion in the mortgage industry. For instance, it is expected that any RESPA reform on the horizon will deal with redisclosure of the good faith estimate if there is a change in the terms beyond some sort of tolerance.

The concept of redisclosure here seems to make sense, especially for any lender that chooses to provide an early disclosure of material loan terms that is not otherwise required by state or federal law. For instance, if a lender provides an early disclosure of material loan terms, it would not want to face a bait and switch claim if the final loan terms are different. Timely redisclosure helps protect against such a claim.

### LOAN PRICING

Ameriquest must use a pricing model for loans that is designed to produce (before application of any price exception) the same interest rate and number of discount points for all potential borrowers with the same credit risk characteristics and who are the same with respect to any other material characteristics (e.g., loan-to-value ratio, type of property, etc). This part of the settlement commits Ameriquest to maintaining a policy that it voluntarily instituted in 2003 as part of a "best practices" initiative.

A "price exception" is defined as the offering of a rate that is lower than the rate for which the borrower otherwise qualifies under the pricing model. To make sure that the use of price exceptions is not undermining the pricing model, the settlement provides that if in any ninety day period the number of borrowers receiving a price exception exceeds thirty percent of the loans originated during that period, there will be a rebuttable presumption that Ameriquest has violated this part of the settlement agreement. However, the term "price exception" does not include a price reduction that is necessary to keep a loan below federal and state "high cost" loan triggers or price reductions in certain other limited circumstances. Thus, loans where pricing is reduced in such cases do not count against the 30 percent cap.

This part of the settlement, along with restrictions on employee compensation discussed below, would seem to eliminate the use of overage pricing by Ameriquest. This is just the latest sign that overage compensation programs are receiving increased scrutiny from regulators and the secondary market. New York, for example, has for the past few years required lenders to describe their policy on overages.<sup>2</sup> The secondary market has also gotten more active in regulating the amount of points that can be charged in a transaction. For instance, Fannie Mae and Freddie

Mac generally limit the total points and fees to 5 percent of the loan amount. Many private investors impose similar restrictions. The public scrutiny of pricing data now captured by HMDA has further highlighted the potential fair lending risk.

Lenders engaged in discretionary pricing need to seriously consider the benefits and risks of continuing to do so, and, at a minimum, should put policies in place (such as back-end closed loan reviews and front-end listening) to minimize the risk that pricing is creating a fair lending issue.

### **BORROWER BENEFIT**

Ameriquest is also prohibited from entering into any non-prime refinance loan that does not “provide a benefit” to the borrower and must document how each such loan provides a borrower benefit. Unlike the federal Home Ownership and Equity Protection Act (HOEPA) and some state high cost lending laws, there is no time limit on the refinancing. Thus, it appears that Ameriquest must perform this borrower benefit test in every non-prime refinance transaction, regardless of when the refinance occurs in relation to the making of the original loan. Note also that the definition of a “non-prime” loan (APR that is two and one half percentage points for first lien loans and five percentage points for subordinate lien loans over the comparable treasury security yields) will capture many loans that are subject to neither HOEPA nor state high cost loan laws.

While this provision is unique to Ameriquest and the particular dictates of the settlement, it should be noted that the concept of “suitability” is becoming more prevalent in the mortgage industry. For instance, with the exception of certain prime loans, Massachusetts requires that a “borrower’s interest” test be run on any consumer mortgage that refinances another consumer mortgage made within the prior sixty months.<sup>3</sup>

On a related point, Ameriquest is prohibited from soliciting borrowers with existing non-prime loans for refinancing within the first 24 months unless: Ameriquest receives a request for a pay-off statement; is contacted by a borrower who inquires about refinancing; or otherwise has a good faith belief that the borrower is considering refinancing. In any case, the refinancing must still provide a benefit to the borrower.

### **INDEPENDENT LOAN CLOSERS; WHISTLEBLOWING**

Ameriquest is required to use “independent” loan closers for the closing of all non-prime loans. A loan closer is “independent” if he is not an employee of the branch office where the loan is originated or a relative of such an employee, and has no

financial interest in the loan being closed other than payment of standard settlement fees.

Each independent loan closer must be given written instructions on the closing and must provide a written report to Ameriquest senior management if the loan closer discovers any unfair, deceptive, misleading or unlawful behavior by any Ameriquest employee in connection with the loan. Further, Ameriquest employees are only permitted to attend non-prime closings if requested by the borrower. The instructions given to the loan closer must require the closer to fully explain the closing process and the loan documents, and prohibit the closer from pressuring or rushing the borrower, including by suggesting that the borrower can use the TILA rescission period to read the loan documents.

This part of the settlement agreement is an example of good, common sense closing practices. While it is unlikely that your “independent” loan closer will have sufficient recollection of a particular transaction in the event there is ever a problem, having policies that show a sensitivity to these issues can only help a lender’s case.

### **LOAN FUNDING**

Ameriquest is required to disburse the funds on all refinance loans on the first business day after the expiration of any rescission period. However, the settlement agreement also acknowledges that Ameriquest need not disburse the proceeds of any loan until it is “reasonably satisfied” that the borrower has not rescinded the transaction, as required by Regulation Z to TILA.

This highlights an often overlooked issue under Regulation Z. The Commentary to Regulation Z gives examples of how a lender can satisfy itself that the consumer has not rescinded (i.e., by waiting a reasonable time after expiration of the rescission period to allow for delivery of a mailed notice by the consumer or obtaining a written statement from the consumer that the right has not been exercised).<sup>4</sup> While these are not the exclusive means of confirming that a consumer has not chosen to rescind, they highlight the fact that a lender is prohibited from disbursing funds until it is reasonably satisfied that the consumer has not rescinded.<sup>5</sup> This is a requirement that is often overlooked by many lenders that simply disburse immediately upon the expiration of the rescission period, without attempting to confirm that the consumer has not elected to rescind.

### **APPRAISALS**

The settlement also establishes a very detailed program dealing with the independence of the appraisal function; in

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particular, in ensuring that the branches play the smallest role possible in the appraisal process. This is achieved by the creation of a panel of qualified, approved appraisers for each state. When a file is opened, an automated system assigns the appraisal to an appraiser based on an algorithm that is designed to limit the discretion of Ameriquest employees. To be selected for a panel, the appraiser must be in good standing with his or her state licensing authority and must have had their past work product audited for quality and compliance if they have previously done appraisals for Ameriquest.

Perhaps most significant, Ameriquest is required to comply with the October 28, 2003, guidance issued by the federal banking agencies, which stresses the need for independent appraisal and evaluation functions.<sup>6</sup> Significantly, an Ameriquest affiliate, Argent Mortgage, entered into a Cease and Desist order with the state of Georgia in September 2005, under which it was essentially required to follow a 2003 White Paper on detecting and deterring mortgage fraud (including appraisal-driven fraud) issued by the Federal Financial Institutions Examination Council.

Given these developments, lenders would be wise to familiarize themselves with the existing federal banking standards on appraisals and property evaluations, subjects on which state law is largely silent. Since at least the early 1990s, the federal banking agencies have established regulations and guidelines on a variety of appraisal and evaluation issues (e.g., independence, licensing versus certification, appraisals versus property evaluations, etc.).<sup>7</sup>

### STATED INCOME LOANS

This part of the settlement prohibits Ameriquest employees from inflating or fabricating the source or amount of a borrower's actual income, or encouraging a potential borrower to do so. In addition, the independent loan closers are required to have the borrower sign a statement at closing certifying that:

- a. The borrower understands that the loan has been approved based on the amount of income reported by the borrower,
- b. The amount of income reported is accurate,
- c. If the borrower's actual income is less than the amount set forth in the application, the borrower understands that there is a significant risk that the borrower will not be able to afford the loan, and
- d. That any false statements may subject the borrower to criminal penalties.

The settlement also requires Ameriquest to employ a reasonableness standard in its underwriting guidelines to deter-

mine that the amount of stated income is appropriate for the occupation and experience claimed. For instance, if the stated income is based on self-employment or a home-based business, Ameriquest must request evidence of the existence of the business.

As stated income loans have become increasingly available in the subprime market over the past few years, these would appear to be prudent underwriting practices for subprime lenders to implement. Remember also that stated income loans are effectively prohibited for loans that meet the HOEPA triggers. When the Fed amended the HOEPA regulations back in 2002, it created a presumption that HOEPA is violated when a lender engages in a pattern or practice of making "high cost" loans without documenting and verifying repayment ability.<sup>8</sup>

### COMPENSATION PROGRAMS

With respect to employee compensation, Ameriquest cannot provide incentives to encourage its employees to include a prepayment penalty, quote a borrower an interest rate that is inconsistent with the "same rate available" provision discussed previously, or otherwise increase compensation based on loan fees or closing costs.

As with the "same rate available" settlement provision, this provision highlights the growing sensitivity toward overage policies and other methods of compensating loan officers based on interest rates, points or other fees obtained above a certain level.

### CONCLUSION

The Ameriquest settlement is only the latest (and likely not the last) salvo in the "regulation by investigation" campaign launched by state banking departments and attorneys general over the last several years. High profile, high dollar settlements like this, the Household and Citi settlements and the Fairbanks settlement in the servicing area effectively create an additional layer of practices for lenders and servicers to seriously consider, since the terms of the settlements often go beyond the specific requirements of existing statutes and regulations governing the mortgage business.

In many instances there is no allegation of a violation of any specific mortgage lending law (such as the charging of an impermissible fee or the failure to give a required disclosure) that underlies the investigation. Instead, the investigations are often premised on more general allegations of unfair or deceptive conduct. The inherent elasticity of such a claim makes it difficult for lenders to see the boundaries. These types of settlements, for good or ill, bring those boundaries into clearer focus.

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It is important to understand that these settlements are not aberrations. The state attorneys general, in particular, have become increasingly active in multi-state investigations of various industries. The subprime mortgage lending business will likely continue to be a focus of attention, especially as the market continues to be roiled by a spike in foreclosures, early payment defaults, and the attendant negative publicity.

The federal banking agencies' nontraditional mortgage guidance, with its focus on appropriate consumer disclosure of the risks and benefits, will likely provide another avenue of investigation for state regulators, as numerous states have adopted the federal guidance.

For now, lenders should use these settlements as a way to gauge their potential exposure. A simple comparison of the

settlement terms to your current lending programs, disclosure practices, pricing and compensation policies, etc. will go a long way toward letting you know whether you may soon find yourself in the regulators' crosshairs.

### NOTES

1. The settlement agreement is publicly available and can be found on most state attorney general and department of banking Web sites.
2. See N.Y. Comp. Codes R. & Regs. tit. 410, §§ 410.8(g), 410.8(h).
3. See Mass. Gen. Laws ch. 183, § 28C; see also 209 Mass. Code Regs. 53.00, *et seq.*
4. See Official Staff Commentary, 226.23(c)-4; Official Staff Commentary, 226.15(c)-5.
5. See 12 C.F.R. § 226.23(c); 12 C.F.R. § 226.15(c).
6. See, e.g., OCC Advisory Letter 2003-9 (Oct. 28, 2003).
7. See, e.g., 12 C.F.R. §§ 34.41-34.47 (Jun. 7, 1994); Interagency Appraisal and Evaluation Guidelines, SR 94-55 (Oct. 28, 1994); OCC Bulletin 2005-6, Frequently Asked Questions on Appraisal Regulations, the Interagency Appraisal and Evaluation Guidelines, and OCC Advisory Letter 2003-9 (Mar. 22, 2005).
8. See 12 C.F.R. § 226.34(a)(4).

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