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Putting the Cork on the Subprime Genie

By Jeff Haynes

Part Three of a Three-Part Series

If only the subprime genie had come offering to grant a wish. Mortgage industry regulators would have instantly wished him back into the bottle.

Absent any magical wishing power, authorities are hoping new legislation, guidelines and stepped-up enforcement will be enough to get a solid handle on the vapory cloud that's casting a dark shadow over the mortgage market.

Federal agencies have issued a new statement on standards for subprime mortgage lending. New bills addressing the issue are circulating in legislative committees at both the federal and state levels. And the Connecticut Department of Banking has been busy citing, fining and shutting down a slew of offenders within the mortgage industry.

"We're going to be more vigilant than we have been," said state Banking Commissioner Howard Pitkin. "We are taking a better look at mortgage banking than we ever have before."

Last week, the DOB issued a cease-and-desist order against troubled New Century Financial Corp. and its subsidiary, Home123 Corp., both based in Irvine, Calif. The order included fines of $1.7 million for New Century and $200,000 for Home123.

The order cites 15 loans New Century closed in Connecticut but failed to fund, in addition to two loans that the company had failed to close after issuing closing documents. Home123 is cited for failing to close two Connecticut loans after having started the closing documents.

In February, the DOB issued a cease-and-desist order to California-based Greater Acceptance Mortgage Corp. for operating an unlicensed office and employing unregistered loan originators. The company is facing a $3.3 million civil penalty.

Likewise, loan originator Mark L. Rhodes – also known as Mark L. Sadie – of Parkland, Fla., has received a cease-and-desist order from the DOB, along with a $600,000 fine. The order accuses Rhodes of fraudulent activity including overstating applicants' incomes and originating multiple loans simultaneously for the same applicant for multiple properties.

Earlier this year, the DOB entered into settlement agreements with Progressive Mortgage and Platinum Mortgage, with the companies paying civil penalties of $12,000 and $1,000, respectively. Both had been cited by the state for hiring unregistered originators.

In addition, the DOB has its case against Middletown-based Mortgage Lenders Network USA. The company, which was building a 305,000-square-foot facility in Wallingford to serve as its new head-

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quarters, has filed for Chapter 11 bankruptcy. Prior to that action, the DOB had issued a cease-and-desist order against MLN, citing violations such as failing to fund loans, employing unregistered originators, not cooperating with the DOB in its investigation and exceeding the state's cap in prepaid finance charges on loans. The DOB also has fined MLN $7.6 million.

With a staff of 120, the DOB has nine examiners to perform field audits and licensing reviews. Department figures put the state's number of companies with first-mortgage licenses at around 3,200. Most of those companies have secondary mortgage licenses as well, meaning the nine examiners have around 6,000 licenses to monitor. That's in addition to keeping an eye on the 26,000 registered originators.

By virtue of the numbers, and the fact that the mortgage industry is having trouble, that particular market has been getting a lot of attention from the DOB, Pitkin said. The DOB typically gets its information on potential violations through routine exams, stories in the media, complaints and insider tips, he added.

'Considerable Time'

The DOB could be getting some assistance from the General Assembly, but the timeline and the final form of the legislation remain unclear.

"The Connecticut DOB views our enforcement issues to be well within our statutory authority presently," said department spokesman James Heckman. "However, we are considering changes in the law that may be introduced in the next session of the General Assembly."

"Regulations may become an option but that process takes considerable time," he added. "We're doing what we can to protect the public in each case that comes to our attention."

One bill that received unanimous approval from the state's Banks Committee calls for licensing individual originators and including their information in a nationwide database. The national, uniform system – operated by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators – would be designed to help states track originators who have run afoul of the law.

While the policy of licensing originators is a decision the Conference of State Bank Supervisors is leaving up to individual states, "the trend is clearly moving in that direction," said Michael Stevens, the organization's senior vice president of regulatory policy.

The states' banking commissioners also are looking to develop a mortgage examiner training program to help the examiners going into the field to perform the audits, he said.

"There's a lot of activity at the state level in terms of enforcement," Stevens said. "It's a big job to get your arms around it."

At the federal level, Rep. Carolyn Maloney, D-N.Y. and chairwoman of the House Financial Service Committee's Financial Institutions Subcommittee, plans to introduce a bill that would include a requirement that lenders consider the ability of a borrower to pay back an adjustable-rate loan over the entire term – not just at the beginning, when "teaser" rates are extremely low, according to Associated Press reports.

"Clearly, there is going to be increased regulation," said Patrick Begos, founding partner of Begos & Horgan, a Westport-based law firm. The firm's areas of practice include debtor and creditor disputes, as well as real estate purchases and sales. "Nobody can predict what shape it's going to take," he said.

Meanwhile, new subprime lending guidelines have been put forth by five federal agencies: the Office of the Comptroller of the Currency, Treasury; the Federal Reserve System's board of governors; the Federal Deposit Insurance Corp.; the Office of Thrift Supervision, Treasury; and the National Credit Union Administration.

The guidelines include rating a borrower's ability to repay adjustable-rate mortgages at the fully indexed rate, and including not only the principal but also the interest, tax and insurance when calculating a borrower's debt-to-income ratio for the mortgage.

And "when underwriting higher-risk loans, stated income and reduced documentation should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity," state the agencies' guidelines. "For many borrowers, institutions should be able to readily document income using recent W-2 statements, pay stubs or tax returns. A higher interest rate is not considered an acceptable mitigating factor."

The agencies put the statement out at the beginning of March, and have scheduled a two-month period for industry input.

"The interagency statement proposes practices and principles to limit risks to both the borrower and the lending institution," said Federal Reserve Board Governor Randall S. Kroszner. "The statement addresses fundamental underwriting and risk-management policies and discusses ways that institutions can provide subprime borrowers with clear and balanced information on the risks associated with these loans."

'A Strong Message'

Government-sponsored enterprise Freddie Mac, which has $165 billion in securities backed by subprime mortgages, has issued its own new standards for subprime lending. As of Sept. 1, the GSE, which is also known as the Federal Home Loan Mortgage Corp., will buy only subprime ARMs – and mortgage-related securities backed by those loans – that have qualified the borrower at the fully indexed and fully amortizing rate. Freddie Mac is looking to limit the use of low-documentation underwriting for those loans and, like the federal agencies, wants the loans underwritten in a way that includes taxes and insurance.

Reaction to the new standards has been mixed.

The steps taken by Freddie Mac "will limit the product options and the access to credit for those individuals most in need, many of whom are first-time, underserved or minority homebuyers," said Washington, D.C.-based Mortgage Bankers Association Chairman John M. Robbins in a prepared statement. "The mortgage products that these new standards target are important financial instruments, crucial to helping borrowers get into homes and repair their credit. Regulation that further limits consumer choice is unwarranted."

Others in the lending industry acknowl-

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edged the importance of keeping subprime loans available.

"It can be an effective and helpful product for consumers, as it represents loan opportunities that people wouldn't otherwise have," said Robert Davis, executive vice president of the Washington, D.C.-based trade association America's Community Bankers.

Groton, Mass.-based mortgage consultant Allen King agreed.

"This [subprime] product is profitable – if it's done right," he said.

Stevens, from the Conference of State Bank Supervisors, said he supports the steps proposed by the federal agencies.

"We're working on a parallel statement," he noted. "Both the state and federal banking agencies have an interest in this area."

In coordinating a federal and state approach to addressing the problem, "it sends a strong message to the market as to what the expectations are," Stevens said.

Begos said he agrees with qualifying borrowers at the fully indexed rate of an ARM.

"You're only paying the teaser rate for one to five years," he said.

He also voiced support of the federal agencies' push to make a loan's total costs more understandable for the borrower.

To avoid a future default, "it seems to me that it would be in the bank's best interest to disclose to the borrower the real-world effect the loan is going to have on them for the next two to five years," Begos said.

Regardless of what happens with the new regulations, Peter Spalthoff, executive director of the Connecticut Society of Mortgage Bankers, said he believes the subprime market will survive.

"The brokers will know where to get it," he said.

The difference is that the price of subprime loans will be more reflective of the risk involved, he said. The loans likely will include more of a commitment from the borrower, he added, meaning the 100 percent and 105 percent loan-to-value mortgages may be history.

"[Subprime lending] will still be out there," Spalthoff said. "But the mortgage broker will have to work a little harder for it." ■

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