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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Mortgage Pricing Scrutiny Poses New Challenges For Lenders

By **Jeffrey Naimon and Benjamin Olson** (February 1, 2018, 1:39 PM EST)

Jeffrey Naimon

Benjamin Olson

Notwithstanding the dramatic expansion of consumer financial protection regulation in the wake of the financial crisis and the Dodd-Frank Act, most would still agree with the general principle that markets, not regulations, should determine the prices that consumers pay for taking a loan. But recent federal and state enforcement actions indicate that, even if regulators are not setting "the right price" for a loan, they are increasingly willing to declare certain prices "wrong." This is a troubling development for mortgage lenders, which face potential action even when their pricing is nondiscriminatory and accurately disclosed. However, there are steps lenders can take to minimize the risk of unwanted regulatory scrutiny.

The Role of Discount Points and Lender Credits in Mortgage Pricing

Mortgage lenders typically offer consumers a range of interest rates to choose from, each of which is generally coupled with a payment by the consumer or the lender. If the consumer selects a rate at the lower end of the range, the consumer will make an upfront payment of discount points to the lender. If the consumer selects a rate at the higher end of the range, the lender will make an upfront payment of lender credits to reduce the costs the consumer is required to pay to close the loan, such as taxes, recording charges and title fees.

Each mortgage lender sets its prices by determining the combinations of rates, points and credits that it will offer to consumers. These pricing decisions are informed by a number of factors, including the expected value of the loan if sold on the secondary market, the lender's costs to originate the loan (including loan officer or broker compensation), and the lender's need to make a profit while offering competitive terms.

We are not aware of any federal or state law that prohibits a lender from offering different prices to two similarly situated applicants, so long as the lender is not discriminating on a protected basis (e.g., race, sex, ethnicity or religion). A lender can offer a 30-year mortgage loan at 4 percent with two points to one applicant and that same loan at 4.5 percent with two points to another applicant, if in doing so the lender is not engaging in impermissible discrimination.

The Application of UDAAP to Mortgage Pricing

Regulators are increasingly scrutinizing mortgage pricing practices and using their authority to prevent unfair, deceptive, or abusive acts or practices to cite lenders for failing to give consumers the "full benefit" of discount points or lender credits.

In November 2017, the Federal Reserve Board entered into a consent order with Peoples Bank in Lawrence, Kansas, to resolve claims that, between January 2011 and March 2015, "many borrowers did not receive a benefit or the full benefit associated with paying Discount Points."[1] Significantly, the Fed stated that, even though the bank provided disclosures to consumers that "gave an accurate quantitative picture of the loans' costs," the disclosures "mischaracterized the nature of those costs because they indicated that a specified portion of the fees paid at closing were being used to purchase a lower, discounted rate, but sometimes that was not accurate."[2] The Fed further stated that the loan disclosures, despite being accurate, misrepresented the rate and discount points because "[a] borrower acting reasonably under the circumstances could have concluded based on the disclosures that the interest rate he or she was purchasing with the Discount Points was lower than what Peoples otherwise would make available to that borrower without the payment of Discount Points."[3]

The New York Department of Financial Services has taken a similar position. Specifically, in a November 2016 consent order, it found that "PHH Home Loans collected fees from borrowers that were charged in exchange for a reduced interest rate. However, these files failed to contain documentation establishing whether such borrowers actually received the promised discounted rates, creating the possibility that PHH may have charged borrowers for services it did not provide."[4]

NYDFS has also taken action against a mortgage lender with respect to lender credits. In August 2017, the agency entered into a consent order based on a finding that:

[W]here borrowers obtained from Veterans United a credit to cover estimated closing costs by agreeing to a higher interest rate (a "lender credit") and where the final closing costs were lower than such estimated costs (resulting in a "surplus lender credit"), Veterans United did not adjust down the interest rate, reduce the principal balance of the loan, reduce the down-payment (if applicable), provide a cash refund, or pursue any other means of refunding the surplus to the borrower.[5]

NYDFS concluded that the lender violated New York law by "selling lender credits to borrowers, yet (1) not disclosing the credit purchased on the Good Faith Estimate, (2) not disclosing to the borrowers that Veterans United would keep the balance of the credit when the closing costs were below the amount of the credit, and/or (3) not disclosing the amount of surplus lender credit."[6]

In all of these actions, regulators noted the failure of the lender to maintain written policies, rate sheets, or other records documenting the relationship between rates and points or credits.

The Application of Other Federal Requirements to Mortgage Pricing

In nonpublic examinations, we have observed an increased interest — particularly by the Consumer Financial Protection Bureau — in whether lender credits are properly disclosed on the new TILA-RESPA Integrated Disclosure forms and whether closing costs paid using lender credits are finance charges that must be included in the annual percentage rate and in the points and fees tests for qualified mortgage and high-cost loan status. As with the UDAAP actions discussed above, a lack of documentation can present challenges in demonstrating to regulators that lender credits are properly categorized because these determinations are generally governed by "the terms of the legal obligation" between the lender and the consumer.[7]

Conclusion

The actions discussed above indicate that, separate and apart from fair lending testing, regulators will scrutinize how mortgage lenders set interest rates in relation to discount points and lender credits. These actions further indicate that, when a lender cannot demonstrate that it applied a consistent, documented pricing methodology, regulators may assume that the lender's pricing practices are unfair, deceptive, or abusive, even when consumers receive the promised pricing and disclosures are accurate.

Lenders can minimize this risk by adopting policies and procedures governing pricing, applying those policies and procedures consistently when communicating with consumers, and documenting pricing decisions on a loan-level basis. However, these controls do not provide a safe harbor and may pose new challenges from a business perspective — just as the combination of fair lending laws and loan originator compensation rules have made it more difficult to give loan-level pricing discretion to loan officers, these controls may make it more difficult to give branch managers discretion to meet the pricing pressures in their local markets. Finally, the actions discussed above leave open the possibility that regulators will seek to delve even deeper into loan pricing in the future.

Jeffrey P. Naimon and Benjamin K. Olson are partners at Buckley Sandler LLP, where they represent financial institutions on a variety of regulatory and enforcement matters relating to mortgage lending and servicing, among other consumer financial services and products.

DISCLOSURE: Naimon represented Peoples Bank in the Federal Reserve Board matter referenced in this article.

[1] In the Matter of Peoples Bank, Federal Reserve Docket No. 17-041-B-SM, at 2 (Nov. 28, 2017) ("Many borrowers who paid Discount Points did not actually receive a reduced interest rate or received a rate that was not reduced commensurate with the price paid for the Discount Points."), available at https://www.federalreserve.gov/newsevents/pressreleases/files/enf20171128a1.pdf. While Peoples Bank appears to be the first federal enforcement action of its kind, it is worth noting that the Fed previously raised concerns about "unearned discount points" in in a 2012 Consumer Compliance Outlook article titled "Compliance Risks for Unearned Discount Points." Available at https://consumercomplianceoutlook.org/2012/third-quarter/compliance-risks-for-unearned-discount-points/.

[2] Peoples Bank at 2.

[3] Id.

[4] In the Matter of PHH Mortgage Corp. and PHH Home Loans at 7-8 (Nov. 9, 2016), available at http://www.dfs.ny.gov/about/ea/ea161109.pdf. Furthermore, in a September 2013 consent order, NYDFS found that Prospect Lending "collect[ed] loan discount fees to reduce the initial rate, but fail[ed] to give borrowers the discounted interest rate associated with such fees." In the Matter of Prospect Lending, at 2 (Sep. 10, 2013), available at http://www.dfs.ny.gov/about/ea/ea130910b.pdf. While New

York law imposes a number of requirements specific to discount points, these consent orders do not make clear the extent to which NYDFS's findings were based on those specific requirements as opposed to general disclosure requirements and prohibitions on misrepresentations and other UDAAPs.

[5] In the Matter of Mortgage Research Center, LLC d/b/a Veterans United Home Loans, at 1 (Aug. 10, 2017), available at http://www.dfs.ny.gov/about/ea/ea170810.pdf.

[6] Id. at 5 (stating that this conduct violated Part 38.7(a)(l) of the General Regulations of the Superintendent, which provides that "[n]o ... mortgage banker ... shall: misrepresent or conceal material loan terms, or make false promises to induce an applicant to apply for a mortgage loan.").

[7] 12 C.F.R. § 1026.17(c)(1); see, e.g., comment 4(a)-2 ("Charges absorbed by the creditor as a cost of doing business are not finance charges, even though the creditor may take such costs into consideration in determining the interest rate to be charged or the cash price of the property or service sold. However, if the creditor separately imposes a charge on the consumer to cover certain costs, the charge is a finance charge if it otherwise meets the definition."); comment 37(g)(6)(ii)-2 ("The creditor should ensure that the lender credit disclosed [on the Loan Estimate] is sufficient to cover the estimated costs the creditor represented to the consumer as not being required to be paid by the consumer at consummation, regardless of whether such representations pertained to specific items.").