Georgia Department of Banking and Finance

# Memo

To: Examination and Professional Staff and Chief Executive Officers of Georgia State Chartered Banks

From: David G. Sorrell, Commissioner

Date: October 3, 2003

Re: Guidelines regarding the Avoidance of Predatory and Abusive Mortgage Lending Practices in Georgia State Chartered Banks

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**Statutory Authority for the issuance of these Guidelines**

The Department is charged with the following objectives under Section 7-1-3 of the Official Code of Georgia:

To provide for:

(1) Safe and Sound operation of financial institutions

(2) Proper conservation of the assets of financial institutions

(3) Public Confidence in financial institutions

(4) Protection for the interests of depositors, creditors and shareholders of financial institutions

(5) Service by financial institutions responsive to the needs and convenience of depositors, borrowers and other customers and conducive to economic progress and to these ends, opportunities to expand services and facilities (emphasis added).

We believe that the guidelines outlined below are consistent with and in furtherance of the Department's statutory objectives regarding state chartered financial institutions.

**The Status of Predatory Lending Statutes in Georgia**

On October 1, 2002 the Georgia Fair Lending Act (GAFLA) became effective as an added consumer protection, which provided certain limitations on lending practices related to residential mortgage lending, impacting lenders, brokers, servicers and assignees and purchasers of mortgage loans. Due to a number of concerns with the original Georgia Fair Lending Act, including concerns with the impact on assignees and the secondary market, substantial changes were made to the Act which became effective on March 7, 2003. Included in these provisions were changes which provided that in the event of preemption of the provisions of the GAFLA, state banks would be similarly preempted from these provisions of the Act.

On July 31, 2003, the Department received written notification from the Office of the Comptroller of the Currency that they had determined that national banks were preempted from the provisions of the GAFLA.

The Department conferred with Georgia's Attorney General to determine if Georgia's Fair Lending Act was properly preempted according to the language of the GAFLA and to determine if state chartered bank's parity provision under the Act should be triggered. The Attorney General's office determined on August 4, 2003, that through the OCC Preemption Determination and Order, federal law "has been determined" by the authorized federal agency to preempt the applicability of the GAFLA to national banks. Therefore, a determination was also made by this Department on August 4, 2003 that Georgia State chartered banks and their subsidiaries would be similarly preempted from the statutory provisions of the GAFLA by a declaratory ruling.

While it is noted that the preemption for state chartered banks is consistent with the provisions of the GAFLA as amended, this Department remains committed to making certain that practices that are predatory or abusive to consumers are actively discouraged and that if other violations of applicable state or federal law are noted, that these violations are cited. In particular, practices which could unfairly or unlawfully threaten the foreclosure of a consumer's residence or result in the stripping of equity are particularly troublesome and objectionable. The Department notes that other federal and state laws related to residential mortgage lending, including the Home Owners Equity Protection Act (HOEPA), the Federal Trade Commission Act and other applicable consumer protection laws continue to apply to both state and nationally chartered banks.

Based on the observation of our examiners and the consumer complaints received by this office, the Department has noted that predatory lending practices have not typically been found in depository financial institutions.

The Department believes that it is important that the preemption of the GAFLA should not be misunderstood as an indication that practices that are clearly objectionable or abusive to consumers will be tolerated or condoned in state chartered financial institutions or their subsidiaries.

The purposes of these guidelines are:

1. To outline certain practices which may be indicative of predatory or abusive mortgage lending practices as noted during examinations or other contacts,

2. To indicate what actions may be taken by the Department in the event that predatory or abusive mortgage lending practices are noted during examinations or through other contacts made by the Department; and

3. To outline safe and sound practices related to brokered or purchased mortgage loans, whether or not these loans appear to be abusive or predatory in nature.

**The Definition of Predatory Lending**

The terms "abusive" or "predatory lending" are not specifically defined by statute or regulation and are the subject of considerable discussion among industry, regulatory and consumer advocacy groups. The Federal Reserve System has noted increasing concerns with predatory lending related to mortgage lending and adjusted the thresholds in HOEPA to reflect their concerns regarding consumer safeguards related to mortgage lending. The Office of the Comptroller of the Currency at the same time they were considering preemption of the Georgia Fair Lending Act, distributed advisory letters with "Guidelines for National Banks to guard against Predatory and Abusive Lending Practices" and "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans". This OCC Guidance reflects a number of practices as possibly indicative of predatory or abusive lending.

In spite of the variety of opinions regarding this subject it is noted that the granting of credit without determination of the borrower's ability to repay the credit, is a strong indicator of abusive credit relationships. Extending credit designed to result in the foreclosure of residential real estate or to facilitate the stripping of equity in that real estate is considered to be abusive or predatory lending. There are also a number of practices which may, depending on the circumstances, be indicative of predatory lending.

**Practices which may be indicative of Predatory Mortgage Lending**

The following practices may be indicative of abusive or predatory mortgage lending. The total circumstances of the credit and the borrower should be taken into consideration:

1. The granting of credit that the borrower clearly cannot repay based on their level of income, the terms of the loan and the other obligations of the borrower.

2. The use of single premium credit insurance or single premium DCC or DSA products on loans secured by residential real estate.

Discussion:

The issue of single premium credit related insurance on mortgage loans is an issue that is a potential concern to the Department and also to the federal regulatory agencies based on their recent guidance in this area. It is the position of the Department that overall, monthly payment credit related insurance products are more favorable to the consumer on most mortgage loans. This position has also been reflected by the General Assembly of Georgia in both the amended and the original versions of the GAFLA.

The Department intends to communicate to both banks and their data processing vendors the importance of making the necessary systems changes and upgrades to accommodate monthly payment alternatives on mortgage loans.

However, it has also been brought to the Department's attention that there may be impediments in the insurance law to use of a monthly payment product on a balloon note. Consequently, until such time as a change is made to Georgia Insurance Laws and Regulations that removes any impediments to the writing of monthly payment insurance on a balloon note, if a financial institution follows the practices outlined below, single premium coverage on a balloon note may be appropriate. The Department intends to communicate with the insurance department regarding possible changes in these limitations on monthly payment products on balloon loans secured by residential real estate.

The Department is also aware that some banks currently have difficulty with either their core processing systems or their loan platforms in accommodating monthly payment products. Due to this situation, the Department will monitor through its examinations vendor and bank progress in establishing a monthly outstanding balance credit insurance product for mortgage loans until June 30, 2004. At this time the vendors and banks should have had time to implement the monthly product for mortgage loans. The Department will then reassess the issue of writing of single premium credit insurance on mortgage loans.

The following guidelines must be followed if such a product is not to be considered predatory or abusive:

a. The term of the coverage must be consistent with the term of the loan. (In other words, the policy length and loan term must be comparable.)

b. The Policy shall fully cover the payoff balance of any loans covered for the life of the loan. (Subject to any limitations in Georgia Insurance laws and regulations.)

c. An equitable method of refund must be used in the event of loan prepayment.

d. The consumer shall be notified in writing that the insurance is not required and that their existing insurance policies may provide adequate protection.

e. Proper disclosures must be made to the consumer that the premium has been added to the loan.

3. The refinancing of government sponsored or other subsidized lending programs without providing a tangible benefit to the borrower.

4. The use of loan “flipping,” the practice of frequent refinancings that result in little or no tangible benefit to the borrower, particularly if these refinancings are characterized by excessive fees.

5. The charging of excessive loan fees, particularly fees which are not reflective of the cost of the lender and which may not be accurately disclosed in the disclosure documentation provided to the borrower.

6. The use of loan rate structures such as negative amortization or accelerated interest rate structures which may be difficult for borrowers to understand and which make it difficult or impossible for the borrower to pay off the loan.

7. The use of balloon payments on real estate loans unless this payment structure is clearly disclosed to the borrower, including the dollar amount of the balloon payment and when this payment will be due. (Note: The use of a balloon payment structure is not inherently abusive and it may make sense for certain borrowers, depending upon their individual circumstances and the structure of the note.)

8. Making loans to pay a contractor for home improvement or repair, when the underlying improvements have not been completed or have not been completed consistent with established building codes or by other acceptable methods, such as controlling disbursement of proceeds.

9. The abusive structuring of prepayment penalties that make it difficult or impossible for a borrower to repay a loan before scheduled maturity. (Note: There are circumstances where prepayment penalties could be beneficial to the borrower, such as for “no fee” mortgage loans where these structures may be needed during the initial years of the loan to accommodate this mortgage structure. The total circumstances of the credit and the benefits to the borrower need to be considered in determining whether such a structure is abusive.)

10. The use of unrestricted “due on demand” features on residential mortgage loans (due on demand features that are unduly controlled by the lender and not based upon default).

11. The use of mandatory arbitration clauses in loan contracts. Applicable case law regarding the use of mandatory arbitration should be considered and provisions that are unduly restrictive or weighted to the benefit of the creditor may be considered abusive.

12. The lack of clear and proper disclosures or the making of misleading disclosures to consumers. (For example, deceptive or misleading fee descriptions on HUD I Forms or other loan documentation.)

13. Targeting inappropriate or costly loan products to financially unsophisticated consumers, especially if these individuals would qualify for more reasonably priced credit products and terms.

**The Department’s response in the event that predatory mortgage lending practices are noted during the examination or visitation process**

The practice of making loans which a borrower clearly cannot repay based on income or other creditable sources of repayment is a fundamentally abusive practice. Such a practice is considered an unsafe and unsound banking practice and is subject to administrative action on the part of the Department, including, if appropriate, formal administrative action.

The response of the Department regarding other potentially abusive or predatory practices will depend on the severity and prevalence of the problems noted. If a situation is observed that appears to be a

singular and isolated incidence, there could be a recommendation in the examination or visitation report, recommending that management review the practice noted for possible corrective attention. A pattern of abusive practices could warrant more serious administrative action based on safety and soundness concerns or violation of various applicable consumer protection laws.

The Examiners of the Department will review the bank's practices to make certain that the bank is in compliance with the provisions of the Home Owners Equity Protection Act (HOEPA), the Federal Trade Commission Act and the Georgia Uniform Deceptive Trade Practices Act.

HOEPA

HOEPA prohibits negative amortization, increases in interest rate upon default and balloon payments for loans with a term of less than five years. It also restricts the use of prepayment penalties and due-on-demand clauses in the first year of the loan, with some exceptions. HOEPA triggers as modified on October 1, 2002, are an interest rate trigger based on 8 percentage points in excess of a similarly termed treasury instrument (10% for subordinate lien loans) and a point and fees threshold of 8 percent of the total loan amount. Violations would be cited in the examination report for any loans which exceed either of these thresholds and which are in violation of any of the HOEPA loan requirements.

FTC Act

State banks are additionally subject to Section 5 of the FTC Act which makes unfair or deceptive acts or practices practiced in commerce unlawful. Practices such as loan flipping, equity stripping and the refinancing of subsidized or special loans without benefit to the borrower can be considered unfair or deceptive practices in violation of this Section of the FTC Act.

In order to be considered ***deceptive*** under the Act, there must be a representation, omission, act or practice that is likely to mislead. It must be likely to mislead a reasonable consumer and the representation, omission, act or practice must be likely to mislead in a material fashion.

In order to be considered ***unfair,*** a practice must cause substantial consumer injury, such as monetary harm, the injury is not outweighed by benefits to the consumer, and the practice must be one that consumers could not have reasonably avoided.

As apparent from the above requirements, the standards for a practice or representation to be considered deceptive or unfair is a fairly high one, however if serious acts are noted which meet the above standards, a violation of Section 5 of the FTC Act may be cited by our examiners. The fact specific circumstances would determine whether the citation of such a violation would be appropriate. Violations of the FTC Act could result in a strong administrative response from the Department to effect corrective action and eliminate the circumstances resulting in this violation of law. This could include a Memorandum of Understanding, Cease and Desist Order or referral to other enforcement authorities.

Georgia Uniform Deceptive Trade Practices Act

State banks and other financial institutions are also subject to the provisions of the Georgia Uniform Deceptive Trade Practices Act, 10-1-370 through 10-1-407 of the OCGA. Section 10-1-372 defines a trade act as deceptive if the conduct "creates a likelihood of confusion or misunderstanding." The circumstances surrounding loan transactions including the loan terms and structure and the adequacy of disclosures made regarding the transactions would determine whether a violation of this law would be appropriate. Loans which contain features or a combination of features which appear to be substantially abusive in nature or which may be deceptive in terms of the adequacy of disclosures to consumers could be cited by examiners as in violation of this Section of Georgia Law. As in the case of Violations of the FTC Act the standard for what constitutes a deceptive or unfair practice is a fairly high standard and would reflect serious and pervasive practices and representations. Section 10-1-391 states that "the purpose of this part shall be to protect consumers and legitimate business enterprises from unfair and deceptive practices in the conduct of any trade or commerce in part or wholly in the state. It is the intent of the General Assembly that such practices be swiftly stopped, and this part shall be liberally

construed and applied to promote its underlying purposes and policies." As in the case of the FTC, if the Department cites a violation of the Georgia Uniform Deceptive Trade Practices Act, a financial institution could face a strong administrative response by the Department to correct the violation and eliminate the circumstances resulting in the violation. This could include a Memorandum of Understanding, a Cease and Desist Order or referral to other enforcement authorities.

## Actions banks can take to minimize the possibility of predatory or abusive mortgage lending practices

As noted above, depository financial institutions have overall done an effective job of providing financial services to the consumer with terms and pricing that are appropriate based on the market. Additionally the financial services marketplace has been able to accommodate consumers with below prime credit and has thereby been able to expand the credit market to individuals that have previously not had access to credit. It is important to maintain this availability of credit, however practices which may be indicative of predatory or abusive lending, as outlined above should be avoided by banks by establishment of appropriate Loan Policies and Procedures, by following sound loan underwriting, by maintaining other appropriate consumer safeguards, and by managing and monitoring these procedures through proper loan review procedures.

### Written Loan Policies

In order to avoid predatory mortgage lending the Department recommends the following practices be addressed in the financial institution's loan policy:

- Testing for HOEPA thresholds and compliance with HOEPA's prohibitions for applicable loans.
- Avoiding any violations of the FTC Act or the Georgia Deceptive Trade Practices Act.
- Making "home loans" (as defined by the GAFLA) with single premium credit insurance.
- Making loans with frequent refinancings unless a demonstrated benefit to the borrower can be shown.
- Making loans refinancing special or subsidized mortgage programs, unless a demonstrated benefit to the borrower can be shown.
- Making loans with negative amortization features.
- Making loans with prepayment features that are not limited to the early years of the loan.
- Guidelines for using balloon payment features for short-term loan transactions.
- Points, Fees and penalties that are excessive, abusive or unjustified.
- Unfair or abusive changes in interest rates or acceleration clauses in the loan contract.
- The use of Mandatory Arbitration clauses (refer to note above regarding these provisions).
- Use of unrestricted "due on demand" features.

### Loan Underwriting Procedures

Following sound credit underwriting procedures including determining the ability of the borrower to properly repay the debt is a fundamental safe-guard against predatory lending. Consideration should be given to the borrower's income, other obligations, employment status and the terms of the proposed loan.

Other Considerations

It is appropriate that when dealing with borrowers that are financially unsophisticated, elderly or otherwise vulnerable, that the bank take appropriate action during the credit approval process to make certain that the borrowing is not abusive to the interests of the borrower and is beneficial to borrower overall. For particular types of credit, such as loans for home improvements where the borrower's equity in their residence is at risk, it is appropriate to take measures in structuring the loan to make certain that the funds are appropriately released to the contractor and that the home improvements were completed to the property.

Credit Review Procedures

A financial institution's internal or external credit review process should include compliance with the above limitations or exclusions regarding credit policies and underwriting procedures.

Management Information Systems

Bank management should have sound management information systems in place to permit the lending function to be properly monitored and to assure adequate compliance with loan policies and procedures.

**Practices related to mortgage loans purchased through brokers or loan participations**

Banks have a responsibility for determining that loans that are purchased from other financial institutions and from mortgage brokers are not abusive or predatory loans. A bank should also perform adequate underwriting procedures on such loans, including review of the loan terms and structure, analysis of the financial information on the borrower and their ability to properly repay the loan and other practices that could be indicative of potentially predatory lending activity. The practices outlined above regarding loan policies and procedures should apply equally to loans originated within the financial institution and loan purchased from other parties.

Loans purchased from brokers and other financial institutions are subject to similar legal requirements, including the Truth in Lending Act, RESPA, HOEPA, the Equal Credit Opportunity Act and the Federal Trade Commission Act. These statutes provide that certain of the prohibited practices under these acts may result in legal risk to purchasers or assignees.

It is imperative that banks, in order to protect against credit, reputational and legal risk establish appropriate Policies and Practices for doing business with mortgage brokers and third party originators. These should include:

- Confirming that the broker or third party originator is properly licensed and has not been subject to any significant regulatory sanctions or actions.
- Assessing the competence and experience of the broker.
- Assessing the business practices of the broker including the adequacy of documentary practices.
- Determining reputation with the industry.
- Assessing financial history and condition.
- Assessing internal controls and procedures.
- Determining that there are no conflicts of interest regarding lending relationships.

It is also recommended that banks have a written agreement with brokers or third party originators outlining the duties and responsibilities of the respective parties to the agreements, including providing that applicable laws and regulations will be complied with, procedures that permit a loan to be returned to the broker or the third party originator in the event that certain conditions (such as apparent fraud or apparent predatory lending practices) are noted in the

credit, that establish other limitations on the credit (such as maximum levels of loan fees) and that establish procedures in the event of a breach of the agreement.

It is also important to perform individual loan reviews on loans purchased from brokers or third party originators. The depth and frequency of these reviews should depend on the volume of loans purchased, the size of the loans and other credit characteristics. Even for high volume standardized portfolio purchases there should be at least a sampling of loans reviewed to insure that proper loan underwriting procedures are followed, that consumer protection and other laws are being followed and that the terms and structures of the loans do not appear to contain predatory or abusive lending practices.

**Mortgage Lending practices of Bank Subsidiaries**

While it has been observed that commercial banks have not typically been associated with predatory or abusive lending practices, it is also noted that banks have established or acquired subsidiaries that may specialize in mortgage lending, consumer finance and other lending activities. Predatory lending practices that occur at a financial institution subsidiary are viewed with as much seriousness as if these practices occur at the bank itself. Possible Credit Risk, Reputation Risk and Legal Risk involved with a bank subsidiary can result in risk to the bank. Examination procedures shall include a review of the activities of bank subsidiaries. The practices outlined above, which may be indicative of abusive or predatory lending should be similarly proscribed, limited or controlled in bank subsidiaries. Bank management should properly monitor the policies; procedures and underwriting that occur at bank subsidiaries and provide for similar safeguards as outlined above. There should be sound management information systems in place to assure that proper management oversight over the lending activities at bank subsidiaries occurs.

Note that subsidiaries of holding companies have not been accorded preemption status regarding the GAFLA; therefore if a subsidiary is not a subsidiary of a state or national bank, they would be expected to comply with the provisions of the Act.

**Third Party Vendors and Servicers**

The Department plans on meeting with vendors and servicers that provide core processing and loan platform services to Georgia state chartered banks. We will continue to work with these vendors regarding practices such as being able to accommodate monthly payment credit insurance products, which the Department regards as generally being more favorable to the interests of Georgia consumers.

**Summary**

The Department has noted both in the process of examining banks for compliance with the GAFLA and by monitoring consumer complaints filed with the Department that state chartered financial institutions have not been involved to any material extent in lending practices that could be characterized as predatory or abusive to consumers. Violations related to the Georgia Fair Lending Act, when applicable, were isolated, inadvertent and were immediately corrected by bank management. All banking agencies, both federal (including the Federal Reserve, the FDIC and the OCC) and state have noted that if such practices are encountered in banks or in bank subsidiaries they will be pursued in accordance with existing guidelines regarding safety and soundness and in accordance with applicable law. While the Department intends for state chartered banks to be accorded parity with national banks on this issue, we do not intend to permit parity to be used to condone or permit practices which are clearly abusive to the consumer. It is our intention to continue our examination procedures to make sure that the practices that may be indicative of predatory mortgage lending outlined in this memorandum are avoided or limited by state chartered banks and their subsidiaries unless they can be demonstrated to be appropriate and beneficial to the consumer. These practices have been routinely avoided and these banks should not have any difficulty meeting the guidelines in this Memorandum. Banks and their subsidiaries can safeguard themselves regarding these issues by establishing proper policies and procedures regarding direct mortgage lending and loans purchased using third parties, following sound loan underwriting guidelines and monitoring compliance through proper loan review and management information systems.