Message from the Chair

To the Members of the Committee on Banking Law:

I am pleased to send you another quality edition of the Banking Law Committee Journal that will be posted on our Committee website. I commend these and the now extensive set of prior articles on our website to you, both in terms of the relevance of the topics covered and the quality of the articles. These articles provide examples of the blending of legal expertise and practical experience that make the Committee very useful for lawyers who represent financial institutions, trade associations, and government regulatory agencies.

Hopefully, this Journal will be the initial step you take in your use of the Committee as well as be helpful in acquiring practical insights in how to understand and address the legal, policy and compliance issues with which you are dealing. The editors are available to discuss their articles in more detail as well as to provide you with the benefit of their extensive experience in the banking industry. They are augmented by others on the Committee who can provide more insights at our meetings. Come to our August meeting in San Francisco or our November meeting in Washington DC at which you can see the benefit of discussing these issues in the company of 200 of your colleagues.

Please also feel free to contribute to the dialogue, including by providing your opinion or analysis on current topical issues. Write a short article for the next edition and send it to any of the editors listed here. You will be speaking to the 1600 members of the Committee. Also, feel free to contact Chris Bellini at cbellini@gibsondunn.com or at our meetings if you want to discuss a proposed article or have other material suitable to be posted on our website for our members.

Jim Scott
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Featured Articles

Safeco Insurance Co. of America v Burr FCRA Lessons for Banks
Charlotte M. Bahin

On June 4, 2007, the United States Supreme Court (the Court) ruled on a case the results of which creditors and all companies that must comply with the requirements of the Fair Credit Reporting Act (FCRA) awaited anxiously. From a compliance perspective the case provides clarification regarding some aspects of the adverse action notice requirements of the FCRA. However, the ruling may cause increased confusion about when such notices are required. The possible confusion notwithstanding, given the lack of guidance in this area, the ruling provides useful direction. While the decision addresses the actions of insurance companies, banks and other creditors are required to deliver adverse actions notices and comply with the
requirements of the FCRA and the lessons of the case can be applied to the issue of when banks are required to give adverse actions notices. The Court also addressed the standard of willfulness for alleged violations of the FCRA.

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Home Ownership Equity Protection Act of 1994
Raymond Natter

Recent Congressional attention to the problems of predatory mortgage lending has led for calls for the Federal Reserve Board to use its authority under the Home Ownership and Equity Protection Act of 1994 ("HOPEA" or the "Act") to provide additional protection for consumers with respect to mortgage loans. This article will review the legislative history and provisions of HOPEA, and explain the scope of the authority of the Federal Reserve Board (the "Federal Reserve" or the "Board") under that statute.

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The Current Subprime Mortgage Environment: Trends and Implications
Travis P. Nelson

The recent decline in the subprime mortgage market undoubtedly will have ripple effects throughout the economy. As the market declined, the perception that subprime loans are akin to predatory loans has grown. While this perception is not necessarily accurate, until recently there has been little comprehensive guidance or standards in the subprime lending market to ensure integrity in the origination process. This article will examine the decline of the subprime lending market and the resulting increased call for suitability standards in the subprime mortgage industry.

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The New Rules of Private Equity Investments & Acquisitions in U.S. Financial Institutions
Thomas P. Vartanian

Unlike prior M&A binges, the 2007 acquisition market is marked not by companies buying companies, but by private equity and hedge fund acquisitions of companies. This trend is increasingly bumping up against federal and potentially state banking laws as acquisitions are attempted of companies that directly or indirectly control or want to control regulated financial institutions (i.e., commercial banks, thrift institutions, CEBA banks, trust banks, credit card banks and industrial loan companies ("ILCs")), often because they really want to control the companies that control those institutions.

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On June 4, 2007, the United States Supreme Court (the Court) ruled on a case the results of which creditors and all companies that must comply with the requirements of the Fair Credit Reporting Act (FCRA) awaited anxiously. From a compliance perspective the case provides clarification regarding some aspects of the adverse action notice requirements of the FCRA. However, the ruling may cause increased confusion about when such notices are required. The possible confusion notwithstanding, given the lack of guidance in this area, the ruling provides useful direction. While the decision addresses the actions of insurance companies, banks and other creditors are required to deliver adverse actions notices and comply with the requirements of the FCRA and the lessons of the case can be applied to the issue of when banks are required to give adverse actions notices. The Court also addressed the standard of willfulness for alleged violations of the FCRA.

In an opinion issued in the consolidation of two cases, both on appeal from the United States Court of Appeals for the Ninth Circuit, *Safeco Insurance Co. of America v Burr* and *GEICO General Insurance Co v. Edo*, the Court took up two issues under the FCRA:

- Whether an insurer who considers an applicant’s “consumer report” when setting the applicant’s rate has the obligation to send an adverse action notice pursuant to section 1681m(a) of the FCRA if the applicant does not qualify for the best possible rate the insurer offers to its customers; and
- Whether a plaintiff must prove a “knowing and intentional” violation of the FCRA in order to establish “willful” conduct under 12 USC 1681o, or whether proof of a defendant’s “reckless disregard” for its statutory obligations is sufficient to meet this standard.

The Court ruled:

- An adverse action can occur at the time of the initial application for insurance, not just at the time of renewal of an existing policy.
- The failure to offer the consumer the insurer’s best premium rate, even if that decision is based on a consumer report, is not necessarily an adverse action triggering the need to provide an adverse action notice.
- At renewal time, only an increase over the prior premium rate class, not an increase over the neutral score, would trigger the adverse action notice requirement.
- “Willful” conduct for purposes of FCRA includes reckless disregard and does not require proof of a knowing or intentional violation.
While Safeco failed to comply with the adverse action notice requirements, such failure was not “willful” and thus Safeco is not liable for statutory damages to the consumers involved, given the lack of clarity in the FCRA.

The Court was not as clear on how to determine whether the rate actually offered to the consumer adversely affects the consumer. Rather than comparing what the consumer was offered to the insurer’s best premium rate class to determine whether the consumer is adversely affected, the ruling directs insurers to compare what was offered to what the premium rate class would be if the consumer had had a neutral score or what the baseline rate would be in the absence of consumer reports used to rate the consumer.

The FCRA was enacted in 1970 and has been amended several times since then. Among other things, the statute requires that any person who takes adverse action with respect to any consumer that is based in whole or in part on any information in a consumer report must notify the consumer. The notice must contain information regarding how to contact the agency that reported the consumer’s credit, must tell the consumer that he or she may receive a free copy of the credit report and dispute its accuracy with the agency.1 In the context of insurance, adverse action is a denial or cancellation of, an increase in any charge for, or a reduction or other adverse or unfavorable change in the terms of coverage or amount of any insurance, existing or applied for.

The Court states that the drafters of the FCRA intended to require notice and prompt challenge by the consumer only when the consumer would gain something if the challenge succeeded. The Ninth Circuit found that notification to the consumer was required if the consumer would have received a lower rate if his or her credit report was more favorable. The Court reversed and found that the approach taken by GEICO which was to first determine the consumer’s neutral score rate was acceptable. This was accomplished by determining the applicable rate without considering the consumer’s credit report and if the resulting rate was higher than the neutral score rate, an adverse action notice would be sent to the consumer. This approach is to be used for new and existing customers.

The benchmark to determine whether a consumer is adversely affected by the insurer’s use of a consumer report in the underwriting process is whether the premium rate class would be offered if either a consumer report with a neutral score had been received or no consumer report had been received. Insurers, banks and creditors may run into obstacles as they establish neutral score rates.

The other significant issue addressed by the Court in this case is that of willful violations of the FCRA. The statute allows consumers the right to seek recovery against creditors for both negligent and willful violations of the FCRA. In order for a consumer to prevail for a negligent FCRA violation, the consumer is required to prove that actual damages are sustained.

The insurance companies argued that the liability under FCRA for willful violations reaches only those actions which may be said to have been carried out in reckless disregard of the company’s statutory duties. They argued that their interpretation of when an increase in rate occurs is

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1 15 USC 1681m(a)
reasonable and, based on that interpretation, their actions were not a willful violation of the statute. The question of whether a willful violation requires a knowing or conscious wrongdoing or whether it only requires a showing of reckless disregard has been the subject of debate among parties involved in FCRA litigation and the result is a split among the circuits.

The Court concluded that “willful” for purposes of FCRA includes reckless disregard and does not require proof of a knowing or intentional violation. The Court based this determination on common law usage of reckless disregard and reasoned that common law has treated actions in reckless disregard of the law as willful violations. The Court then defined reckless disregard as requiring a high risk of harm, objectively assessed. Further, the Court found that a company has not acted in reckless disregard of the FCRA unless the action is not only a violation under a reasonable reading of the statute, but shows that the company ran a risk of violating the law substantially greater than the risk associated with a reading that was merely careless.

The objective reasonable test is a high bar to overcome. The consumer must show that the company’s interpretation was not only unreasonable but it was so unreasonable as to create an unjustifiably high risk that the company adopting it would be in violation of the law.

In the Safeco case, the Court’s finding that the insurer’s violation was not objectively unreasonable was aided by the lack of guidance on the issue in the statute, from the Federal Trade Commission and the split in the circuits. Because of all of these factors, the Court found that the company’s interpretation of the FCRA was not objectively unreasonable and fell short of raising the unjustifiably high risk of violating the statute necessary for reckless liability.

For all companies subject to the FCRA and its requirements, this opinion effectively means that compliance decisions reached in good faith, concerning unsettled areas of law, should not give rise to willful liability under FCRA so long as those decisions are not objectively unreasonable.
HOME OWNERSHIP EQUITY PROTECTION ACT OF 1994

Raymond Natter

Recent Congressional attention to the problems of predatory mortgage lending has led for calls for the Federal Reserve Board to use its authority under the Home Ownership and Equity Protection Act of 1994 (“HOPEA” or the “Act”) to provide additional protection for consumers with respect to mortgage loans. This article will review the legislative history and provisions of HOPEA, and explain the scope of the authority of the Federal Reserve Board (the “Federal Reserve” or the “Board”) under that statute.

Legislative History and Statutory Provisions

HOPEA was enacted in 1994 in response to Congressional concerns over “reverse redlining.” According to the Senate Banking Committee report accompanying the legislation, “reverse redlining” is the practice of targeting residents of specific disadvantaged communities for credit on unfair terms, and in particular by second mortgage lenders, home improvement contractors, and finance companies. These lenders were felt to “peddle high-rate, high-fee home equity loans to cash-poor homeowners.” According to the legislative history, the law is not designed to cover purchase money mortgages, but only first and second closed-end loans with high fees and costs, that are used to “skim” the built up equity in the homes of vulnerable consumers. The legislation was also intended to only target the abusive loans, “without materially restricting the flow of credit or imposing an excessive burden on lenders or consumers.”

To achieve these goals, HOPEA establishes a class of residential mortgage loans (for purposes of this article only, these loans will be referred to as “high cost”) that are subject to special disclosures and other requirements. A high cost loan is defined as a closed-end, non-purchase mortgage loan, secured by a consumer’s principal residence, that has an annual percentage rate in excess of 10 percent above Treasury securities with a comparable maturity, or that has total fees and points that exceed the greater of $400 or 8 percent of the total loan

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4 Id.

5 A closed-end loan is a loan for a specific amount of money to be repaid over a fixed term. An “open-end” loan is a loan in which the borrower has the right to take additional advances during the loan term, and the line of credit varies depending upon the outstanding balance.

6 Id. at 22.

7 Id. at 23.
amount. The Federal Reserve is given authority to adjust these triggers, within certain parameters. As adjusted by the Board, the current triggers are 8 percent above Treasuries for a first loan, and 10 percent above Treasuries for a second loan, and the fee trigger has been raised to the greater of 8 percent of the loan or $547 to reflect inflation.8

High cost mortgages are subject to additional disclosure requirements, which must be made at least 3 days prior to the loan closing. The Act imposes substantive restrictions on these loans, including prohibitions on prepayment penalties (unless certain conditions are met),9 penalty interest rates in the event of a default, balloon payments for short-term loans, and negative amortization features. A creditor may not engage in a “pattern or practice” of extending credit through high cost mortgages without regard to the consumers’ repayment ability, including current and expected income, obligations, and employment.

Under the Act, a purchaser or assignee of a high cost mortgage is subject to all claims and defenses that could have been raised against the maker of the loan, unless the assignee demonstrates that a reasonable person, exercising ordinary due diligence, could not determine based on the documents and other disclosures that the mortgage was a “high cost mortgage.”

The Fed’s Regulatory Authority

The Federal Reserve is given the authority to issue implementing regulations, including the authority to modify the definition of a “high cost mortgage” by adjusting the triggers. Specifically, the Act permits the Board to set the APR trigger at any amount between 8 percent and 12 percent above Treasury securities with comparable maturities. The Board is also required to adjust the $400 fee trigger to reflect changes in the consumer price index.

The Board may, by regulation or order, exempt specific mortgages or categories of mortgages from any or all of the HOEPA requirements, or prohibit additional acts or practices in connection with any mortgage (not just “high cost mortgages”) that the Board determines are unfair, deceptive, or designed to evade HOEPA, or that are made in connection with a refinancing of a mortgage loan that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.10 Finally, the Board is given the general regulatory power to issue “such regulations as may be necessary” to carry out HOEPA.

The Board initially issued implementing regulations in 1995.11 In 2001, the Board amended these regulations to broaden the coverage of the Act and to prohibit certain practices.

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8 12 C.F.R. § 226.32 and Supplement I.

9 The loan may include a prepayment penalty if certain conditions are met and if the penalty does not apply 5 years after the date of the loan origination.


that the Board determined where unfair, deceptive, or designed to evade HOEPA. The 2001 amendment extended the scope of coverage of HOEPA by lowering the trigger for first mortgage loans from 10 percent above comparable Treasuries to 8 percent. The fee-based trigger was adjusted in 2001 by including optional credit insurance and other debt protection products written in connection with the extension of credit.

**Potential Board Actions**

- The Board could further reduce the percentage trigger, so that a first or second loan that has an APR of 8 percent or more above comparable Treasuries is covered.
- The Board could further revise the definition of “fee” to encompass a broader range of charges that are not included in the finance charge under the Truth-in-Lending Act.
- The Board could modify required disclosures for high cost mortgages.
- The Board could widen the presumption that a lender is making high cost loans without regard to the borrower’s repayment ability.
- The Board could proscribe additional practices or mortgage terms for any mortgage deemed as being unfair, deceptive, or designed to evade HOEPA, or with respect to the refinancing of any mortgage loans that the Board determines are abusive or not in the best interests of the borrower.

**Regulatory Authority With Respect to Non-HOEPA Loans**

While HOEPA is primarily concerned with high cost loans, it also provides the Board with the authority to proscribe certain practices with regard to all mortgage loans. In particular, the statute states:

> The Board, by regulation or order, shall prohibit acts or practices in connection with –

(A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and

(B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.

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Unlike the definition of high cost mortgage, which is limited to non-purchase money, closed-end loans, this section of HOEPA refers to “mortgages” generally. Thus, based on the literal language, it appears to encompass all types of mortgages, and not just those that meet the definition of a high cost mortgage. Indeed, logic also dictates this interpretation, since one of the purposes of this section is to enable the Board to regulate mortgages that are “designed to evade” the provisions of the HOEPA law, presumably by not meeting the definition of a high cost loan.

The term “mortgage” is not defined in HOEPA or in the Truth-in-Lending Act, which is amended by HOEPA. Under traditional principles of statutory construction the word’s usual and customary meaning should be used. The usual meaning of the term “mortgage” is a lien secured by real property, and the term does not differentiate between closed-end or open-end loans. However, it could also be argued that the legislative history of HOEPA indicates the law was not designed to cover purchase money mortgages, but only first and second closed-end loans with high fees and costs, that are used to “skim” the built up equity in the homes of vulnerable consumers. In either case, the term “mortgage” would appear to cover a first or second closed-end loan secured by real estate. It may be argued that it should not be interpreted to cover purchase money loans and lines of credit. However, in light of the use of term “mortgage” without qualification in the statute, the Federal Reserve would have ample authority to encompass all types of mortgage loans within the scope of any regulation it promulgates.

With respect to the substance of any regulatory action, it is clear that HOEPA gives the Board the power to regulate any act or practice that the Board determines is “unfair, deceptive, or designed to evade the provisions of [HOEPA].” This appears to provide ample authority, for example, for the Board to prohibit the practice of extending mortgage credit (or a category of mortgage credit) that does not take into consideration the ability of the borrower to repay the loan at a fully indexed rate. Similarly, Board regulations could provide that certain types of mortgage loans cannot have a negative amortization feature, or that certain additional disclosures must be made. In fact, all of the requirements in the existing and proposed regulatory guidance could be applied to all mortgage lenders through this section of HOEPA.

With respect to re-financing transactions, the Board’s authority includes the ability to prohibit any act or practice that it determines is “abusive” or that is “otherwise not in the interest of the borrower.” This authority could justify the Board taking any number of actions, including all of those in the recently promulgated and proposed guidance. The Board could also require that for certain borrowers the lender would have to document that a refinancing transaction is in the “best interest of the borrower.”

**Assignee Liability**

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14 The Truth-in-Lending Act refers to “residential mortgage transaction,” defined as a “transaction in which a mortgage ... is created or retained against the consumer’s dwelling to finance the acquisition or initial construction of such dwelling.” 15 U.S.C. § 1602(w).


Assignee liability only applies to mortgage loans that meet the definition of “high cost” loan. The Board’s authority to modify the definition of a “high cost loan” is limited to: (i) adjusting the APR trigger (between 8 and 12 points above Treasuries); (ii) changing the definition of a “fee” to include additional charges; and (iii) adjusting the fee trigger to reflect inflation. If a loan meets one of the triggers, an assignee will have liability for the actions of the maker, unless the assignee can demonstrate that the reasonable person could not determine that the loan was a “high cost” loan based on a review of all of the loan documentation.

If a loan does not meet the APR or fee trigger, the HOEPA assignee liability provision does not apply.17 So for example, if the Federal Reserve Board issued a regulation under HOEPA prohibiting prepayment penalties for all mortgage loans that have an APR that is 5 or more points above Treasuries, a loan that was made in violation of this regulation would not result in assignee liability unless the APR was 8 or more points above Treasuries (the HOEPA trigger).

Private Actions and Class Actions

A lender that violates any of the provisions in HOEPA, including the Board’s implementing regulations, may be liable in a private action or class action. Thus, if the Board prohibits prepayment penalties for loans with an APR that is 5 points above Treasuries, a lender who makes such a loan in violation of the regulation will be subject to potential class action suits. The Truth-in-Lending Act provides a limit on class action recoveries.

State Attorney General Actions

A State Attorney General may also bring an action to enforce HOEPA or the Board’s implementing regulation, after giving notice to the appropriate Federal agency, e.g. a Federal banking agency if the action is against an insured depository institution. The Federal agency may intervene in the proceeding and remove the case to Federal court.18

Right of Rescission

A high cost mortgage that contains a term prohibited by HOEPA or the Board’s regulation is deemed to be a failure to deliver a material disclosure under the Truth-in-Lending Act. As a result, the borrower has a three year period to rescind the loan.

Agency Enforcement

Violations of HOEPA, including Federal Reserve regulations, are enforced against non-depository institutions by the Federal Trade Commission.19 The Act and regulations are

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17 Assignee liability could also be imposed by regulatory action, for example, if the Board requires certain loans to state on the face of the document that assignees are subject to all claims that could be made against the originating party. However, there is nothing in HOEPA that would mandate such action.


enforced against insured depository institutions by the appropriate Federal banking agency, e.g. the Comptroller of the Currency for national banks. As noted above, State Attorneys General may also enforce violations of HOEPA and the Board’s implementing regulations.

**Criminal Penalties**

A person who willfully and knowingly fails to comply with HOEPA or the Board’s regulation may be subject to a criminal fine or imprisonment.\textsuperscript{20}

\textsuperscript{20} 12 U.S.C. § 1611.
The Current Subprime Mortgage Environment: Trends and Implications

By: Travis P. Nelson¹

The recent decline in the subprime mortgage market undoubtedly will have ripple effects throughout the economy. As the market declined, the perception that subprime loans are akin to predatory loans has grown. While this perception is not necessarily accurate,² until recently there has been little comprehensive guidance or standards in the subprime lending market to ensure integrity in the origination process. This article will examine the decline of the subprime lending market and the resulting increased call for suitability standards in the subprime mortgage industry.

The Decline of the Subprime Market

Subprime lending came to life when investment bankers had the idea of purchasing mortgages from bank lenders, packaging them and issuing bonds to finance the purchases with the packaged mortgages as collateral. This practice of mortgage securitization has created enormous wealth for investors, but also has created an incentive structure that encourages originators to write riskier loans, collect fees and transfer the risk to investors.

The remarkable growth in the subprime market in the last 10 years is primarily the result of two distinct factors: investors’ incessant search for higher yields, and ordinary Americans’ pursuit of the American dream of homeownership – at whatever the cost or terms. Subprime loans grew rapidly in the late stages of the housing boom due to strong demand among households that were unable to acquire property in the housing market through traditional financing. Borrowers who cannot make the required downpayment, and who lack sufficient income to access traditional lenders, have flocked to subprime lenders.

Subprime loans are mortgages made to borrowers who generally have credit scores of 620 or below. Such scores often result from a record of paying debts late (or not at all) and other credit blemishes. Since these borrowers are viewed as high risk, their loans carry interest rates that are often at least 2 percent higher than those offered to traditional borrowers, and may contain risk compensating features, such as prepayment penalties. Examples of typical subprime mortgage products include:

- **Balloon Mortgages** – the borrower only pays interest for the first 10 or 15 years, after which a big lump-sum is due.
- **“No doc” or “Low Doc” Loans** – the lender accepts the borrower’s stated income without any supporting documentation.

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- Piggy-back Loans – the combination of a first and second mortgages eliminates the need for the typical 20 percent downpayment.
- Teaser Loans – the borrower may qualify for an artificially low interest rate for an initial term of, for example, three years, and then the rate adjusts – requiring higher payments that are less affordable for the borrower.
- Stretch Loans – the monthly payments represent more than 50 percent of the borrower’s gross income.
- 2/28 Loan – a type of teaser loan product that is nearly exclusive to the subprime market, 2/28 loans have an adjustable rate that is fixed for the first two years, and then adjusts to a rate index plus a margin.\(^3\)

To properly understand today’s problem, one must consider the current subprime environment in view of a nearly 20-year economic cycle. Following the recession of the early 1990’s, the country entered one of the longest periods of economic growth in the past 60 years due in large part to the imposition of tight monetary controls by Federal Reserve Chairman Alan Greenspan and a government posture friendly to economic supply-siders ushered in by the 1994 election of a Republican majority in Congress. This environment allowed mortgage originations to hold steady at around $1 trillion a year. Due to the stable environment, the Federal Reserve initiated interest rate reductions in 2001 that had an immediate impact on the mortgage market. As interest rates declined and home values increased, borrowers took advantage of the opportunity to refinance existing loans and cash-out equity. This also allowed increased opportunity for first-time home buyers. The result was a dramatic expansion in the mortgage market from 2001 to 2004, peaking in 2003 at just under $4 trillion in new originations. When demand for new loans slowed in 2004, the market was left with overcapacity, prompting originators, urged by investors hungry for increased yields, to shift to more “innovative” products. Accompanying these innovative products were relaxed underwriting standards and temporary payment reductions, increasing risk for both borrowers and lenders.

For the past two years, subprime lending has constituted approximately 20 percent of the mortgage loan market share. As an example of the current trend in subprime loan performance, a recent nationwide survey conducted by the Mortgage Bankers Association showed that 14.44 percent of subprime borrowers with Adjustable Rate Mortgage (ARM) loans were at least 60 days delinquent in their payments in the fourth quarter of 2006. This was a 122 basis point increase over the same rate from the previous quarter. Foreclosure rates for subprime loans also increased 18 basis points during the fourth quarter of 2006.

Similar to the savings and loan crisis of the 1980’s, the decline in the subprime market has the potential to affect a variety of industries. For example, real estate (increased foreclosures may cause lower overall sale prices and an oversupply of housing inventories), retailers (retail sales may decline as customers’ discretionary spending contracts, especially retailers that draw price-sensitive consumers), and home improvement companies (for consumers facing foreclosure, home improvement may become a low priority). The ripple effect of the subprime mortgage market downturn will be felt immediately for the investors who sought the

\(^3\) Some of these issues have been discussed in the Interagency Statement on Subprime Mortgage Lending, discussed infra.
opportunities for high yields available in mortgage securitized assets. Unlike the savings and loan industry, however, where the losses were born by individual banks and their owners, due to securitization of mortgage-backed assets traded in the secondary market, the subprime loan losses will be diluted among investors worldwide rather than concentrated in the institutions that originated the loans.

Members of Congress have called for a temporary moratorium on subprime loan foreclosures and greater regulatory controls. During this session, Congress may seek to modernize the Federal Housing Administration to enable it to attract many consumers who would otherwise be drawn to subprime lenders. Additionally, this legislative season may draw amendments to the Home Ownership Equity Protection Act (HOEPA) to broaden the scope of loans covered under the Act’s protections.

Consumer advocates also are calling for a federally mandated home loan suitability rule, similar to what is currently in place for investment securities. As discussed in detail below, those who support such a measure argue that a federal suitability standard, and the enforcement of such a standard, would deter predatory lending practices that may exist in the subprime market, while permitting appropriate innovation of new products. Opponents of a suitability standard argue that it is ill-placed in a home mortgage market where affordability is key, and where such standards might lead to frivolous lawsuits. There are also different public policy considerations underlying homeownership that are absent in securities investments.

On the regulatory side, several federal agencies may take action to address subprime lending. The Federal Reserve Board may issue new regulations in an attempt to set uniform federal guidelines to replace the hodgepodge of federal and state laws and regulations affecting the subprime loan market. In 2006, more than half of the subprime loans originated were done subject to exclusive state regulation. There is still some question regarding whether the Federal Reserve can do this under its existing rules, or whether additional legislation is required to authorize such rulemaking. The Federal Trade Commission (FTC) also may take a more aggressive enforcement posture, such as labeling some practices “unfair and deceptive.” Unlike the Federal Reserve Board, the FTC may be able to take action more quickly, without a legislative fix, through a more aggressive reading of the Real Estate Settlement Procedures Act (RESPA), which governs disclosures to consumers about settlement costs and mortgage processes.

**Suitability**

There are many who have attacked the current laws and regulations governing the subprime lending industry as inadequate. Such critics argue that “contract law, disclosure, and consumer counseling fail because they place the onus on highly vulnerable victims to refrain from signing loans, rather than on the lenders and brokers who perpetrate these loans.” These critics also suggest that fraud laws and antidiscrimination laws are too narrow in scope, and price

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regulation has extensive adverse effects. The answer, as such critics argue, is a suitability requirement imposed by law.

Origins of Suitability: The Securities Model

In the 1930’s, the National Association of Securities Dealers (NASD) first adopted the concept of “suitability,” proposing the notion that a salesperson “should recommend only securities that are suitable to the needs of the particular customer.” The suitability doctrine has developed in the disciplinary rules of the securities industry self-regulatory organizations (SROs), and appear in the regulations and holdings of the Securities and Exchange Commission (SEC), as well as court decisions in private securities fraud claims under Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) and Rule 10b-5.

Rule 2310 of the NASD’s Rules of Fair Practice provides:

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

The rule also states that prior to executing a recommended transaction for a non-institutional customer, all NASD member broker-dealers must make “reasonable efforts to obtain information concerning”: (1) the customer’s financial status; (2) the customer’s tax status; (3) the customer’s investment objectives; and (4) such other information used or considered to be reasonable by such broker-dealer in making recommendations to the consumer.

In the regulatory adjudication arena, regulators have extended securities fraud beyond common-law fraud to include “acts that violate the obligation of fair dealing” by “professional broker-dealers and their salesmen.” This principle has led to the position that recommending unsuitable securities to customers “violates the obligation of fair dealing.”

Under the two major approaches to determining that an unsuitable investment constitutes fraud, the courts have held that a broker-dealer cannot “recommend a security unless there is an adequate and reasonable basis for such recommendation.” In order for this “reasonable basis” to exist, broker-dealers must do a reasonable investigation and base their recommendations on

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7 17 C.F.R. § 240.10b-5.
8 NASD Rules of Fair Practice, NASD Manual (CCH) ¶ 2310(a), IM 2310-2.
9 Id.
12 Hanly v. SEC, 415 F.2d 589, 597 (2nd Cir. 1969).
the results of the investigations.\textsuperscript{13} Such recommendations must also consider the risk thresholds of the customer.\textsuperscript{14} As suitability does not guarantee future performance, broker-dealers are not liable for securities that were suitable when purchased but that later suffered disappointing results for reasons beyond the salesperson’s control.\textsuperscript{15}

The suitability doctrine as developed by the SEC and the courts has rejected the notion that investor consent can cure otherwise unsuitable transactions. For example, in Phillips \& Co.,\textsuperscript{16} the SEC held that a “broker is obligated to observe [the suitability requirement] regardless of a customer’s wishes.”\textsuperscript{17} In Phillips, the SEC affirmed a NASD finding that a broker violated the NASD’s suitability rule by advising people of limited means to buy oil stock that he knew was too speculative for their financial circumstances, even though the customers voluntarily consented to the purchases.\textsuperscript{18} Later, the Commission suggested that even when customers are fully competent, disclosures might not be sufficient to cure suitability violations,\textsuperscript{19} thus apparently embracing a suitability requirement that cannot be waived by disclosures or customer consent.

Critics have also likened subprime lending to boiler-room practices. The SEC has applied the suitability doctrine to boiler-room sales of penny stocks when brokers recommend stocks without obtaining information on their customer’s financial circumstances or risk preferences. Boiler-room operations refer to high-pressure sales of low-cost, speculative securities through cold calls over the telephone to unfamiliar and unsophisticated customers. For example, in Mac Robbins \& Co.,\textsuperscript{20} the SEC held that it is fraud for a broker-dealer “to induce a hasty decision by the customer” where “no effort [was] made by the salesman . . . to determine whether the security recommended [was] suitable for the customer.”\textsuperscript{21}

\textit{Suitability is Unsuitable for Mortgage Lending}

Notwithstanding the appeal of having a well-developed body of precedent to serve as a model for applying a suitability standard to the subprime market, suitability is an inappropriate approach for the lending market.

Unlike the securities context, where a broker assumes the role of an agent and thus has a fiduciary duty to act in the client’s best interest, lenders are not agents of the borrower, as they are the counterparty to the borrower, acting in their own best interests. Attempting to impose a suitability standard on lenders would alter the fundamental nature of the relationship. In addition

\textsuperscript{13} Id.
\textsuperscript{14} Mundheim, \textit{supra} note 11, at 449.
\textsuperscript{15} See, e.g., Arnold S. Jacobs, \textit{5C Litigation and Practice Under Rule 10b-5} 211.01[b], at 9-63, 9-64 (1994).
\textsuperscript{16} 37 S.E.C. 66, 70 (1956).
\textsuperscript{17} Id.
\textsuperscript{18} Id. at 67-70; \textit{accord} Stephen Thorlief Rangen, Exchange Release No. 38,486, 52 S.E.C. 1304, 1311 (Apr. 8, 1997) (upholding New York Stock Exchange’s liability findings and sanctions for advising customers of limited means to invest in highly speculative margin purchases and excessively trading the accounts).
\textsuperscript{19} Whitman \& Stirling Co. 43 S.E.C. 181, 182-183 (1966).
\textsuperscript{21} Cohen \& Rabin, \textit{supra} note 8, at 1140.
to this basic difference in roles, the allocation of financial risk in the two types of transactions also illustrates the difference: in making an investment, it is the investor who is taking the market risk; in making a loan, it is the lender who takes the credit risk. Although arguably there are certain risks inherent in the mortgage lending environment, such as foreclosure, credit score/history, and bankruptcy, that militate in favor a suitability standard. Though these factors are influenced by the conduct of third parties, such as job loss, and the ability to pay one’s debts as they become due, the borrower exercises far more control over these variables than the investor in the securities context. Even interest rate fluctuations, or initial teaser rates, are known to the borrower prior to the transaction, thus the borrower has the ability to avoid the pitfalls of these risks. Conversely, unlike securities investment, where the investor only stands to lose money, a borrower on a mortgage loan risks the loss of shelter, thus the public policy considerations may caution in favor of suitability notwithstanding the borrower’s limited control over the risks.

The only workable solution to the ills of predatory lending is objective standards, coupled with targeted enforcement. Regulations that provide objective rules as to what constitutes a predatory loan, with several possible triggers to invoke predation status, appear to be the only workable solution. Such objective standards must be imposed at the national level, so as to avoid the hodgepodge of state regulations that will drive lending costs up, and create a patchwork of uncertainty for both borrowers and lenders.

**Impact of Interagency Guidance**

On June 29, 2007, the federal bank regulatory agencies – the Office of the Comptroller of the Currency (OCC), the Federal Reserve System (FRS), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (collectively, the “Agencies”) – issued final guidance on subprime mortgage lending (“Interagency Guidance”).

The Interagency Guidance provides direction for banks, savings associations, and credit unions, and their subsidiaries, holding companies, and nonbank subsidiaries of those holding companies, covering such areas as risk management practices, workout arrangements, consumer protection principles, control systems, and supervisory review. As with other interagency guidance, this document has caused those in the industry some concern that it will be used by plaintiff’s lawyers to form the basis for a standard of care for alleging the unsuitability of loans. The Agencies have tried to dispel such notion that the Interagency Guidance establishes such a suitability requirement:

The Agencies disagree with the commenters who expressed concern that the proposed statement appears to establish a suitability standard under which lenders would be required to assist borrowers in choosing products that are appropriate to their needs and circumstances. These commenters argued that lenders are not in a position to determine which products are most suitable for borrowers, and that

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this decision should be left to borrowers themselves. It is not the Agencies' intent to impose such a standard, nor is there any language in the Statement that does so.

Notwithstanding such a disclaimer, the Agencies have little control over the view that judges and juries take of such comprehensive best practices in the narrow field of subprime mortgage lending. For example, on June 6, 2007, a federal jury awarded $220,000 to an 82-year-old borrower who sued a mortgage company for certain actions that the borrower claimed violated the New Jersey Consumer Fraud Act. In this case, the plaintiff borrower alleged that the mortgage company, EquiHome, engaged in an unconscionable business practice in violation of the New Jersey Consumer Fraud Act by soliciting a mortgage that was not suitable for him. The plaintiff argued that EquiHome representatives convinced him to refinance his non-recourse reverse mortgage with no monthly payments, a credit line of $76,000, and no risk of foreclosure, for a $223,000, thirty-year conventional fixed rate mortgage with monthly payments of $1,300 and a cash pay out of $52,000. The plaintiff, whose primary income source was $965 per month from Social Security, defaulted on the loan within one year of its closing. A jury found that EquiHome’s conduct in soliciting the loan violated the New Jersey Consumer Fraud Act and entered a $220,000 verdict in the plaintiff’s favor. This verdict will now be trebled under the New Jersey Consumer Fraud Act and the plaintiff will be entitled to recover his attorney’s fees and costs associated with bringing suit. Although no opinion was published discussing the application of a suitability standard, it is likely that future plaintiffs will attempt to argue that where mortgage lenders run afoul of the Interagency Guidance, such should render loans unsuitable and therefore actionable.

Conclusion

Subprime loans are not intrinsically evil – quite the contrary – they have served the purposes for which they were designed: generating high investment yield and creating opportunities for home ownership. At the end of the day, this subprime experience has shown policymakers the need for greater consumer disclosure. Even before legislative and regulatory intervention, consumers can avoid some of the pitfalls of subprime lending by being aware of:

- potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires
- the existence of any prepayment penalties, how such will be calculated and when penalties may be imposed
- the existence of any balloon payment
- whether there is a cost premium attached to a reduced documentation or stated income program
- the requirement to make payments for real estate taxes and insurance, if not escrowed, in addition to loan payments, and the fact that taxes and insurance costs can be substantial.

Whether the current debate over subprime lending will result in fundamental change, for better or worse, to this market for those with limited access to banking services remains to be

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seen. It is certainly possible that this is merely a passing fad attributable to the agenda of a Democrat majority in Congress that has been stewing on the outside, anxiously awaiting the opportunity to correct what they perceive as a problem in the market. It is also possible that policymakers on both Pennsylvania Avenue and Wall Street will take a hard look at the practices of mortgage lenders, and the important role that they play, both on a micro and macro level, in the furtherance of the American dream. However long the debate lasts, what is likely to result is a correction on the part of legislators, regulators, the courts, and the marketplace to make the subprime mortgage lending environment more transparent and more informed.
The New Rules of Private Equity Investments & Acquisitions
in U.S. Financial Institutions

By

Thomas P. Vartanian

Unlike prior M&A binges, the 2007 acquisition market is marked not by companies buying companies, but by private equity and hedge fund acquisitions of companies. This trend is increasingly bumping up against federal and potentially state banking laws as acquisitions are attempted of companies that directly or indirectly control or want to control regulated financial institutions (i.e., commercial banks, thrift institutions, CEBA banks, trust banks, credit card banks and industrial loan companies (“ILCs”)), often because they really want to control the companies that control those institutions.

Interestingly, there have been some recent private equity acquisitions where financial institutions have participated in three distinct and very different ways: (i) as lenders; (ii) as equity investors; and (iii) as targets of private equity investments. Some transactions may actually put some institutions in the unique position of being the lender, investor and target (e.g., through the sale or investment in an affiliate) all at the same time, raising issues regarding compliance with bank investment, affiliate transaction and holding company rules. Finally, the fact that it is no longer readily apparent from a company’s name whether it is or owns a financial institution or financial institution holding company, requires that there be a careful analysis under federal and state banking laws of all investments before they are made. For example, in the recent acquisitions of GMAC by Cerberus, and First Data Corp. by KKR, their FDIC-insured Utah and Colorado industrial loan company subsidiaries were not really the targets, but their existence triggered substantive bank control rules requiring prior approval by the FDIC.

Where the control of any FDIC-insured financial institution that will remain in existence is in question, it will trigger prior approvals required under the federal Change in Bank Control Act (“CIBCA”), Bank Holding Company Act (“BHCA”), and/or Savings & Loan Holding Company Act (“SLHCA”) Act as well as potentially under state law. Typically, commercial companies have not been able or willing to acquire or take controlling interests in banks. The aggregate effect of activity, investment, capital, examination and federal enforcement restraints have been enough to convince most companies that life as a regulated bank holding company (“BHC”), savings and loan holding company (“SLHC”), or ILC holding company (“IHC”) is not very attractive. Indeed, a type of “poison pill” exists for those companies that acquired thrift institutions prior to 1999 when the Gramm-Leach-Bliley Act (“GLB Act”) leveled the playing field with respect to commercial banks and thrift institutions and prohibited non-financial companies from buying thrift institutions. Companies like American Express Company, E*TRADE, Federated Department Stores, GE, General Motors, John Deere, Lehman Brothers,

1 Mr. Vartanian is a partner in the DC Office of Fried Frank Harris Shriver & Jacobson. This article is excerpted from a new book entitled “Equity Investments and Controlling Acquisitions Involving U.S. Financial Institutions,” which he is co-authoring on investments in and control of financial institutions in the new private equity and hedge fund acquisitions market. It is scheduled for publication in September 2007. The author has represented parties discussed in the transactions presented in this article.
Morgan Stanley, Nordstrom, Inc. and Allstate are all registered SLHCs, and BMW, Franklin Templeton Credit, Sallie Mae, Pitney Bowes, UBS and Volkswagen are IHCs and own FDIC-insured ILCs in Utah. That means that, as a general matter, no one can acquire 10% or more of a class of the voting stock of these parent entities, and in some cases 5% or more, without getting prior federal and/or state regulatory approval.

**Getting the Deal Done**

A number of creative ways exist to structure an investment in or acquisition of a regulated financial institution and/or the companies that control them (e.g., BHCs and SLHCs) without triggering either control or holding company requirements. They include: (i) dispersing ownership among equity holders and ensuring that they do not act in concert so that their shares are not aggregated for the purposes of determining control; (ii) executing passivity agreements that give up the right to have representatives on the Board of Directors, conduct proxy contests or otherwise influence the management of the company; (iii) using non-voting and other convertible securities; and (iv) nominating voting trustees who can step in the shoes of an equity holder and shield the holder from the consequences of control.

**Dispersed Ownership and Disaggregated Investors**

Investors seeking to invest in a financial institution or its intermediate and/or ultimate holding company can unwittingly find themselves in a control position under the CIBCA, the BHCA or the SLHCA if their investment is aggregated with other investors under the acting in concert rules. Conscious parallel behavior with regard to the control of voting securities in the same financial institution or its holding company may result in the stock of each of those persons or entities being attributed to each other and aggregated for purposes of determining the existence of control and the need for control filings to be made. Where such filings have not already been made before the investment or acquisition, an enforcement action may be brought by the appropriate federal or state banking agency imposing divestiture, other remedial actions and significant fines. In some cases, criminal prosecution can ensue.

However, changing the typical acquisition structure or reconstructing the relationship between investors, partners and related parties can provide a workable means of avoiding such control and potential holding company status. Parties that normally might have invested as one private equity group may segregate their interests and form separate entities or trusts to control the investment target and/or execute passivity agreements to avoid triggering control and holding company requirements.

Several recent transactions have demonstrated how the chain of control can be broken, and the aggregation of voting stock by individuals or companies acting in concert avoided. For example, separate trusts among a number of equity investors each controlling less than 9.9% of the voting stock were used in the purchase of 26.58% of the shares of HSH Nordbank AG, to whom the BHCA is applicable because of the bank’s maintenance of a branch in New York City. In the recently proposed recapitalization of Doral Financial Corporation in Puerto Rico, a number of private equity investors invested as limited partners in a limited partnership (“LP”) that owned substantially all of the limited liability corporation (“LLC”) that is to serve as the acquisition entity. The limited partners would each own less than 9.9% of the voting interests and 9.9% of the equity of the LP. Several of the limited partners will be entitled to designate a representative to serve as one of the directors of the general partner (“GP”) of the limited
partnership. The proposed transaction is conditioned upon Federal Reserve Board confirmation that the equity investors will not be deemed to control Doral Financial, the LLC, LP or GP.

Using Non-Voting and Convertible Securities as Investment Vehicles

Voting stock may trigger control and holding company issues. Therefore, non-voting securities, such as preferred stock, convertible debt, warrants and options, may be employed in an acquisition structure to isolate and protect certain investors from control and holding company issues. Where preferred stock, options, rights and warrants include a future convertibility feature into voting securities, in determining whether the instruments will be treated as non-voting for banking law purposes, various federal rules may, however, look to whether the instrument that carries potential voting rights, is immediately convertible at the time it is issued, or whether the holder is vested with the preponderant economic risk in the underlying voting stock. Generally speaking, an investor may be permitted to acquire preferred stock and avoid control and holding company status as long as the preferred stock: (i) does not provide the holder with the ability to vote for or otherwise affect the selection of the issuer’s board of directors; (ii) constitutes a passive investment or financing device that does not provide the holder the ability to direct the issuer’s management or policies or with a significant equity interest in the issuer (generally greater than 25%); and (iii) limits voting rights to the type of rights ordinarily provided by state law with regard to matters that adversely affect the rights of the stockholder.

Instruments that are immediately convertible into voting stock are generally viewed by the regulators as tantamount to the ownership of the underlying securities. However, the Office of Thrift Supervision, for example, would not consider the preponderant economic risk of an instrument as vested in the holder (meaning that the ownership of the underlying stock would not be attributed to the holder) if the holder has paid less than 50% of the amount required to directly acquire the underlying stock and has no other economic interest in it. Thus, if structured properly, the combination of voting securities, non-voting securities and convertible instruments may be used to satisfy both the investment profile desired and avoid a finding of control under applicable federal control regulations. Each of the federal banking agencies have a set of criteria that differ from each other regarding the various characteristics used in determining whether and when convertible instruments may trigger control filings.

Voting Trust Arrangements

A voting trust may allow an investor or group of investors to complete an acquisition without being subject to the restrictions that may normally apply in a traditional controlling investment or acquisition. A voting trust can be most helpful to facilitate a transaction where a regulated institution is a subsidiary of a larger company being acquired. Generally, a voting trust arrangement would provide the trustee with the authority on voting issues affecting the financial institution or a company that controls the financial institution. Such an arrangement would preclude any voting influence by the beneficiaries and would not allow the beneficiaries to remove the voting trustee, except for cause, or to dissolve the voting trust. Thus, from a regulatory perspective, the owners of the stock would not control the bank or thrift, and therefore may negotiate an arrangement with the regulators that will provide for a quicker prior approval (or non-disapproval of the notice) and less substantive restrictions on the owners. Only the trustee would need to file the CIBCA notice, submit personal biographical and financial information and undergo the CIBCA process.
In cases where voting trustees have been used, they have tended to be persons very familiar to the regulators, and in many cases, former regulators themselves.

**Conclusion**

Investments in and acquisitions of financial institutions are changing, much as the M&A market is changing in this country. The fact that there are large amounts of investing funds looking for good investments means that creative structures will continue to evolve to provide those funds access to investments in companies that may control financial institutions and in financial institutions themselves.