OVERVIEW OF MORTGAGE INDUSTRY LAWS AND REGULATIONS IN WASHINGTON STATE

Introduction

Over the course of the past two years, the Washington State Legislature and the State Department of Financial Institutions have addressed licensing requirements for mortgage professionals and concerns related to predatory lending. The tightening of existing licensing laws and the creation of a law to prevent predatory lending have resulted, in part, from the subprime lending crisis and the decline of the mortgage lending market.

At a time when default and foreclosure rates are high and funds for new loans are less plentiful, stricter oversight of all mortgage professionals is inevitable. Across the country, state legislatures have revised licensing requirements to apply to a broader range of individuals who must satisfy stricter standards to earn a license. Those who succeed in obtaining a license have higher professional standards to meet than those that existed only a few years ago. In this environment, compliance with state and federal lending laws and regulations is a concern that requires greater attention than ever.

The following course is intended to help mortgage lenders, brokers, and loan originators who conduct business in Washington to understand the state’s statutory and regulatory requirements that govern their activities. The first half of the course reviews the requirements of the state’s two licensing laws for mortgage professionals. These are the Mortgage Broker Practices Act (MBPA) and the Consumer Loan Act (CLA). The second half of the course outlines the provisions of Washington’s predatory lending law, which is called An Act Relating to Homeownership Security, Responsible Mortgage Lending, and Improving Protections for Residential Mortgage Loan Consumers.

Department of Financial Institutions (DFI website)

The Department of Financial Institutions (DFI) is responsible for providing regulatory oversight for financial service providers in the state of Washington. It consists of a five divisions which regulate various categories of financial service entities:

- Division of Administration
- Division of Banks
- Division of Consumer Services
- Division of Credit Unions
- Division of Securities

DFI is headed by the Director of the Department of Financial Institutions. The individual in the Director’s position is appointed by the Governor of the State of Washington.
Division of Consumer Services (DFI website)

The Division of Consumer Services is the agency within DFI responsible for the licensing and regulation of mortgage brokers. The Division’s mission statement “…is to protect consumers from illegal and fraudulent lending practices.” The Division further states that it is a self-supporting agency, with its funding provided by “licensing, auditing and policing of regulated businesses and individuals.” The Division does not receive revenue from the state’s General Fund or other public sources.1

The Division of Consumer Services lists its authority as including:

- Licensing
- Conducting examinations of books and records
- Investigating consumer complaints
- Enforcing state and federal statutes and rules relating to lending practices

The Mortgage Broker Commission (RCW 19.146.280)

The Washington Mortgage Broker Commission acts in an advisory capacity on mortgage broker issues to the Director of DFI. It is made up of seven members who serve two-year terms. Mortgage brokers and loan originators serve as members. The Director, or a designee, also serves as a non-voting member of the Commission.

Washington’s Mortgage Licensing Laws

In the 1980s, changes in tax laws, banking laws, and the secondary market allowed nontraditional lenders and mortgage brokers to emerge as regular players in the mortgage lending business. The growth of the mortgage brokering business was phenomenal. Statistics showed that “In 2001, mortgage brokers were originating more than $1 trillion in loans annually. This was equivalent to roughly 55 percent of all mortgages originated in the United States....” 2

Working independently of regulated financial organizations such as banks and savings and loans, mortgage brokers and non-depository lenders (such as mortgage bankers) were negotiating and making loans without direct accountability to any regulatory agency. Unfortunately, the growth and success of the business lured some unscrupulous players, prompting state and federal legislators to propose regulatory controls for this new group of mortgage professionals.

Federal legislation lagged behind state initiatives, and state agencies that regulated financial institutions became the primary regulators of mortgage brokers, non-depository lenders, and related mortgage professionals. In 1993, the Washington State Legislature enacted the Mortgage Broker Practices Act (MBPA) to create requirements for the unregulated members of the

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1 http://www.dfi.wa.gov/cs/about.htm
mortgage lending industry. Washington’s **Department of Financial Institutions** is responsible for the implementation and enforcement of the MBPA.

In the recent past, the MBPA regulated mortgage lenders and brokers. However, in 2008, the Washington State Legislature passed Senate Bill 6471, which “…removed the ability to make loans under the Mortgage Broker Practices Act by deleting ‘making a residential mortgage loan’ from the definition of mortgage broker.” ³ Beginning on June 12, 2008, non-depository lenders were required to obtain a license under the Consumer Loan Act (CLA). The Department of Financial Institutions is also responsible for the implementation and enforcement of the CLA.

**Activities Regulated Under the Two Acts (DFI website – MBPA FAQs; WAC 208-620-230; WAC 208-620-260)**

With brokers and non-depository lenders regulated by two different laws, the Department of Financial Institutions has sought to eliminate confusion over the roles of mortgage professionals that are licensed under the MBPA and those that are licensed under the CLA. According to the Department of Financial Institutions, mortgage brokers are allowed to: ⁴

**Broker Loans:** Brokering loans includes helping a borrower to obtain a residential mortgage loan, and closing the loan in the name of the lender.

**Table-fund Mortgage Loans:** In table-funding transactions, brokers close loans in their own names and sell or assign the loans immediately after closing to the lender that provided the funding.

**Serve as a Non-delegated Correspondent:** When serving as a loan correspondent, a broker has a line of credit and uses the line of credit for loan funding. After the closing, the correspondent holds the loan in its “warehouse inventory” until a loan purchaser in the secondary mortgage market buys the loan. A correspondent is “non-delegated” when the lender that funds the credit line does not delegate underwriting responsibilities to the correspondent. Instead, the lender providing the line of credit specifies the underwriting criteria that borrowers must meet and makes the final underwriting decisions.

Note that as of January 1, 2010, a mortgage broker must hold a CLA license in order to act as a non-delegated correspondent.

Licensees under the Consumer Loan Act are allowed to:

**Fund Mortgage Loans:** Function as loan companies, loan correspondents and mortgage bankers by providing funds for mortgage loans or by funding loans that they originate. (WAC 208-620-230)

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Broker Mortgage Loans: In its regulations that are published in the Washington Administrative Code (WAC), the Department of Financial Institutions provides that licensees under the Consumer Loan Act “...may broker residential mortgage loans under the Consumer Loan Act or Mortgage Broker Practices Act.” (WAC 208-620-260)

Revisions to the Two Acts

Both the MBPA and the CLA have been subject to numerous revisions since the time of their enactment. Recent changes to these laws were necessitated by the federal law known as the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (S.A.F.E. Act). Congress adopted the S.A.F.E. Act to ensure that all state-regulated mortgage professionals across the country are subject to similar regulatory requirements. The law seeks to achieve this goal by requiring all states to meet the following standards for its licensees and registrants:

- Use of the Nationwide Mortgage Licensing System (NMLS) for the filing of license applications and registrations
- Establishment of a system of licensing for all loan originators
- 20 hours of pre-licensing education (minimum), two of which are Washington State Laws (pursuant to Washington law)
- Eight hours of annual continuing education (minimum), plus one additional hour of Washington State law (pursuant to Washington law)
- Criminal background checks
- Surety bond and net worth requirements
- Reporting of enforcement actions to the NMLS

Since Congress passed the S.A.F.E. Act, the Department of Financial Institutions and the Washington State Legislature have made changes in the state’s mortgage lending laws and regulations to comply with the S.A.F.E. Act standards. In 2008, the Department of Financial Institutions made changes to its MBPA regulations to require that all license applicants file their applications through the NMLS. In 2009, the Legislature made changes to the MBPA to ensure that the law meets the requirements of the S.A.F.E. Act.

The following sections of the course will provide a review of the MBPA, the CLA, and related regulations. A discussion of the Washington Usury Law is also included. Before discussing the specific requirements of these laws, the course will review the process of filing a license application with the NMLS.

Those mortgage professionals that are regulated under the MBPA and the CLA should be aware that the regulations adopted by the Department of Financial Institutions are an excellent resource for managing compliance issues. The Department has written its regulations in question and answer format, and regulated individuals and entities are likely to find a direct answer to questions that may arise with regard to licensing, notice requirements, and mandatory disclosures.
They are available online:


Mortgage professionals can also find current information on revisions to the regulations by visiting these web pages.

**Definitions (WAC 208-660-006; RCW 19.146.010)**

**Loan Originator:** means a natural person who:

- Takes a residential mortgage loan application for a mortgage broker, or
- Offers or negotiates terms of a mortgage loan, for direct or indirect compensation or gain, or in the expectation of direct or indirect compensation or gain. “Loan originator” also includes a person who holds themselves out to the public as able to perform any of these activities.

“Loan originator” does not mean persons performing purely administrative or clerical tasks for a mortgage broker. Under Washington law, administrative or clerical tasks is defined as “…the receipt, collection, and distribution of information common for the processing of a loan in the mortgage industry and communication with a borrower to obtain information necessary for the processing of a loan. A person who holds himself or herself out to the public as able to obtain a loan is not performing administrative or clerical tasks.” (WAC 208-660-006; RCW 19.146.010 (11)(a))

**Computer Loan Information Systems or CLI System:** Refers to a real estate mortgage financing information system used by a mortgage broker, loan originator, lender, real estate agent, or other person that provides information to consumers regarding interest rates and other loan terms available from different lenders. (WAC 208-660-006; RCW 19.146.010 (4))

**Independent Contractor or Person who Independently Contracts:** means any person that expressly or impliedly contracts to perform mortgage brokering services for another and that with respect to its manner or means of performing the services is not subject to the other’s right of control, and that is not treated as an employee by the other for purposes of compliance with federal income tax laws. (WAC 208-660-006; RCW 19.146.010 (10))

**Loan Processor:** means an individual who performs clerical or support duties as an employee at the direction of and subject to the supervision and instruction of a person licensed, or exempt from licensing, under Chapter 19.146 RCW. (WAC 208-660-006; RCW 19.146.010 (12))

**Lock-in Agreement:** means an agreement with a borrower made by a mortgage broker or loan originator, in which the mortgage broker or loan originator agrees that, for a period of time, a specific interest rate or other financing terms will be the rate or terms at which it will make a loan available to that borrower. (RCW 19.146.010 (13))
Mortgage Broker: Means any person who for compensation or gain, or in the expectation of compensation or gain:

- Assists a person in obtaining or applying to obtain a residential mortgage loan, or
- Holds himself or herself out as being able to assist a person in obtaining or applying to obtain a residential mortgage loan

(WAC 208-660-006; RCW 19.146.010 (14))

Mortgage Loan Originator: has the same meaning as “loan originator.” (WAC 208-660-006; RCW 19.146.010 (15))

Designated Broker: means a natural person designated as the person responsible for activities of the licensed mortgage broker in conducting the business of a mortgage broker under this chapter and who meets the experience and examination requirements set forth in RCW 19.146.210(1)(e). (WAC 208-660-006; RCW 19.146.010 (6))

Person: means a natural person, corporation, company, limited liability corporation, partnership, or association. (WAC 208-660-006; RCW 19.146.010 (17))

Submitting License Applications to the NMLS (NMLS website)

The Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) established the NMLS as an online database and licensing system “…that will streamline the licensing process for both regulatory agencies and the mortgage industry by providing a centralized and standardized system for mortgage licensing.”

Use of the NMLS became a requirement when Congress passed the S.A.F.E. Act. Now, all mortgage brokers, mortgage bankers, and loan originators who obtain their licenses from state regulators must begin submitting license applications to the NMLS.

The NMLS charges a nonrefundable processing fee with the submission of initial and annual renewal applications. These fees are:

- $100 for a license
- $20 for a branch office
- $30 for each loan originator

The NMLS has also created application forms that license applicants must use, and these include:

Form MU1: This is the form used by business entities and sole proprietors seeking a license as a mortgage lender, mortgage broker, or loan servicer. It requests information on the name,
address, organization, and ownership of the business. The form also requires applicants to complete criminal action, civil action, regulatory action, and financial disclosures and requires personal identifying information on owners, officers, and control persons.

**Form MU2:** License applicants must submit this form along with the MU1 form. It requests biographical information for individuals identified as control persons and as the “qualifying individual” on the MU1 form. There is no separate fee for processing this form.

**Form MU3:** A license applicant must submit this form with the MU1 form if it is opening a branch office. The form is also used for additional branch offices that a licensee opens after obtaining its initial license.

**Form MU4:** This is the form used by individuals seeking a license as a loan originator. It requests information on the applicant’s name, address, gender, and date and place of birth. The form also requires applicants to complete criminal action, regulatory action, civil action, and financial disclosures. Through this form, applicants give authorization for all current and former employers and law enforcement agencies to provide the information pertinent to the applicant’s fitness to serve as a loan originator. License applicants must sign this portion of the application before a notary and obtain the notary’s seal.

In addition to the information provided to the NMLS, applicants must satisfy jurisdiction-specific requirements, which typically include, but are not limited to:

- Fingerprints
- Credit reports
- Net worth requirements
- Surety bond requirements
- Authorization to conduct business in the state

License applicants must submit the jurisdiction-specific information directly to the Washington Department of Financial Institutions.

**Mortgage Professionals and Loans Regulated by the MBPA**

Washington’s MBPA defines the statutory requirements for obtaining a license as a mortgage broker or as a loan originator employed by a mortgage broker. In order to be able to identify the types of mortgage professionals and loans that are subject to the requirements of the MBPA, it is necessary to understand the definitions that the law gives to the following terms: (WAC 208-660-006; RCW 19.146.010 (10))

**Mortgage Broker:** A mortgage broker is an individual or a business organization such as a corporation, partnership, or limited liability company that earns compensation by:

- Assisting a person in applying for or obtaining a mortgage loan
- Holding himself/herself out as an individual or entity that can make or assist a person in obtaining or applying to obtain a residential mortgage loan

**Loan Originator:** A loan originator is an individual who:
- Takes a consumer’s application for a mortgage loan for a mortgage broker
- Earns compensation or expects to earn compensation by negotiating or offering to negotiate the terms of a mortgage loan

The MBPA also creates specific requirements for a **designated broker.** A designated broker is an individual who is responsible for the business activities of a licensed mortgage broker. There is not a separate licensing requirement for designated mortgage brokers. However, as we will discuss in a subsequent section, designated mortgage brokers must meet examination and experience requirements.

**Residential Mortgage Loan:** A residential mortgage loan is a loan for personal, family, or household use that is secured by a mortgage or a deed of trust against residential real estate with an existing single family dwelling or a multiple family dwelling of four units or less. The definition also applies to unimproved residential real estate on which the borrower intends to construct a single-family dwelling or a multiple-family dwelling of four units or less. (WAC 208-660-006; RCW 19.146.010 (19))

**Exemptions (WAC 208-660-008)**

Although there are a number of exemptions to the MBPA, the state has eliminated some of those that previously existed.

As a general rule, only those entities and individuals that are heavily regulated by another federal or state agency qualify for the exemption from the requirements of the MBPA. Those who believe themselves to be exempt should review the regulations carefully.

**Individuals and Entities Exempt From the MBPA**

The following are exempt from all requirements of the MBPA:
- **Commercial Banks, Bank Holding Companies, Savings Banks, Trust Companies, Savings and Loan Associations, Credit Unions, and Real Estate Investment Trusts** and their subsidiaries and affiliates are exempt as long as state or federal regulators are supervising their mortgage banking activities
- **Licensees under the Consumer Loan Act** who are conducting business under the authority of the Consumer Loan Act
- **Persons carrying out an order of a court**
- **Attorneys:** Pursuant to the MBPA, an attorney is exempt if he/she is “an attorney licensed to practice law in this state who is not principally engaged in the business of negotiating residential mortgage loans when such attorney renders services in the course of his or her practice as an attorney.”
- **Real estate brokers or salespersons licensed in Washington**, who obtain financing for the purchase of real estate but receive only the customary real estate broker’s or salesperson’s commission and no additional commission for assisting in the financing of the real estate purchase

- **Real estate brokers that use a Computer Loan Information System (CLI System)** to provide homebuyers with information on lending rates, terms, and lenders. The exemption applies as long as the CLI provider complies with the rules for CLI systems, and provides the consumer with a written disclosure that advises him/her to contact a mortgage broker or lender in order to obtain a loan. The exemption does not apply if the real estate broker represents that he/she can obtain a loan from a lender, accepts a loan application, accepts a deposit for third party services, negotiates a loan, provides a Good Faith Estimate, or performs other services that mortgage brokers provide.

- **The United States, all states, and their agencies and divisions**

  (WAC 208-660-008 (1))

  The following individuals are exempt from the mortgage loan originator licensing provisions:

  - An individual who offers or negotiates the terms of a residential mortgage loan with (or on behalf of) an immediate family member, or
  - An individual who offers or negotiates the terms of a residential mortgage loan which is secured by a dwelling that served as his or her own residence

  (WAC 208-660-008 (2)(a-b))

**MBPA Licensing Requirements for Mortgage Brokers, Loan Originators and Branch Offices**

The MBPA creates one set of application requirements for mortgage brokers and a separate set of requirements for loan originators. These requirements are outlined below.

**Application Requirements for Mortgage Brokers (WAC 208-660-163; NMLS website)**

In order to secure a license from the State of Washington to conduct business as a mortgage broker it is necessary to fulfill each of the following requirements:

- Complete an application form, using the uniform mortgage licensing forms (MU1 and MU2) created for participation in the NMLS (these forms are available on the NMLS website and on the website for the Department of Financial Institutions)

- Prove the identity of the owners, principals, officers, and the designated broker and provide their fingerprint cards

- Pay an application fee of $1,001, which includes the NMLS processing fee (the application fee is subject to increase every two years)

- Pay a branch office application fee of $205, which includes the NMLS processing fee
- Obtain a surety bond that is sufficient to cover the number of licensed loan originators that the mortgage broker intends to employ (The exact amount of the bond depends on the number of employees, as outlined in the section on “Ability to Assume Liability.” However, the total amount cannot exceed $60,000)

The law allows the Department of Financial Institutions to issue an **interim license** for a mortgage broker if the license applicant has “substantially fulfilled the requirements for licensing.” The rules state that application requirements are “substantially fulfilled” when:

(WAC 660-163)(14)

- The application is complete
- Application fees are paid
- The Department has reviewed the results of the applicant’s background check

The purpose of an interim license is “...to facilitate the business of a mortgage broker.” (RCW 19.146.210 (6))

Upon approval of the application, the mortgage broker must pay an annual assessment fee of $530 (WAC 208-660-550). The license is valid for one year and must be prominently displayed in the licensee’s business location. (WAC 660-163)(13);(20))

**Application Requirements for Loan Originators (WAC 208-660-350)**

In order to secure a license from the State of Washington to conduct business as a loan originator it is necessary to fulfill each of the following requirements:

- Complete an application form, using the uniform mortgage licensing form (MU4), which is available on the website for the Department of Financial Institutions
- Pay an application fee of $155, which includes the NMLS processing fee (this fee is subject to increase every two years)
- Provide proof of identity
- Provide fingerprint cards
- A criminal background check
- Complete 20 hours of pre-licensing education
- Pass the National and Washington licensing tests, developed by NMLS, with minimum scores of 75%

Information included on the MU4 form such as a credit report, employment history, and history of any administrative, civil or criminal violations allows the Department to assess an applicant’s professional financial fitness to serve as a loan originator.
Application Denial (WAC 208-660-350)
The Department may deny an application in the following circumstances:

**Failure to show ethical and professional fitness** due to license revocations in any state, cease and desist, convictions of a gross misdemeanor involving dishonesty, or pleas of nolo contendere to a felony within the past seven years. An applicant may be found unfit due to convictions, guilty pleas, or pleas of nolo contendere for a felony at any time, if the felony was related to fraud, dishonesty, or money laundering.

Also included in overall good standing is timely fee payments to the NMLS and filing of the mortgage broker annual report (for mortgage brokers), compliance with surety bond requirements, and appointment of a designated broker.

**Failure to show financial fitness** due to outstanding liens, including tax liens, foreclosures within the past three years, and a pattern of seriously delinquent accounts within the past three years.

When loan originators obtain a license, neither they nor the mortgage brokers who employ them are required to display it. However, they must produce evidence of their licensing status for anyone who requests it. Licenses are valid for one year, and must be renewed by the expiration date of December 31st.

Application Requirements for Branch Offices (WAC 208-660-195)

In order for a mortgage broker to obtain a license for a branch office, the following must occur:

- File an application with the Department of Financial Institutions with an application fee of $205, which includes the NMLS processing fee
- Show that the licensed mortgage broker is in good standing
- Show that the mortgage broker’s surety bond is sufficient to cover the loan originators working in the branch office
- Verify the physical location listed in the application as a branch office location
- Create and be prepared to maintain a written supervisory plan

Licenses for branch offices must be prominently displayed and must be renewed annually.

Additional Licensing Requirements

The licensing requirements outlined above are the general requirements for obtaining a license as a mortgage broker or a loan originator. It is easier to remember many of the specific requirements for obtaining a license by considering the goals that these requirements are intended to meet.
The primary goals of the license application process are to ensure that licensees practice mortgage lending with:

**Professionalism:** The Department of Financial Institutions grants licenses only to those individuals and business entities with adequate knowledge, financial stability, and ethical fitness to work as mortgage professionals

**Accountability:** Mortgage brokers must be accountable for their actions and the actions of the loan originators who work as their employees

**Ability to Assume Liability:** The Department of Financial Institutions grants mortgage broker licenses only to applicants who can show that they are able to pay for losses for which they are liable

**Responsibility for Clients’ Funds:** Licensees must be prepared to maintain and protect clients’ funds

Outlined below are the specific licensing requirements created by the MBPA and the administrative rules of the Department of Financial Institutions. These requirements are grouped according to the general goal that they seek to achieve.

### Professionalism

Washington law uses experience, character and education requirements to establish basic professional standards for mortgage professionals. The law also requires the use of criminal background checks to screen for those who are entering the mortgage profession for the wrong reasons. Following is an outline of the steps that the Department of Financial Institutions takes during the license application process to ensure the professionalism of mortgage brokers and loan originators.

#### Assessing the Personal and Financial Fitness of Applicants

In order to assess the professional fitness of a license applicant, the Department of Financial Institutions examines the personal information of all owners of an unincorporated applicant, and the personal information of any director, officer, or shareholder, or if a corporate applicant, any principal shareholder with an ownership interest of 10% or more of a corporate applicant. The personal information that the license application must provide is:

- A biographical statement that includes:
  - Name, address, date of birth and social security number
  - Any convictions for felonies or for misdemeanors involving fraud
  - Lawsuits or administrative actions before a financial regulatory authority
  - Bankruptcy filings within the past ten years
- Employment history for the past ten years
- Background check
Experience Requirement for Designated Brokers (WAC 208-660-250)
To ensure that the activities of a mortgage broker are supervised by an experienced professional, the law requires that mortgage brokers name a designated broker who has a loan originator license and at least two years of experience in lending or originating residential mortgage loans. The experience must occur within the five-year period that immediately precedes the license application. Acceptable experience includes work as:

- A mortgage broker
- A designated broker of a mortgage broker
- Mortgage banker, or a responsible individual or manager of a mortgage banking business
- Originator of loans secured by a lien on real state
- Manager or supervisor of loan originators
- Mortgage processor or underwriter

The rules require that the designated broker prove his/her work experience using a detailed work history and tax returns.

Designated brokers must pass an examination similar to that of loan originators. After meeting the experience and examination requirements, a designated broker is allowed to serve as the designated broker for more than one licensed mortgage broker. Mortgage brokers must notify the Department of Financial Institutions within five business days of the loss of or change in the designated broker. (WAC 208-660-400(9)

Financial Requirements for Designated Brokers (WAC 208-660-250(2))
An applicant is regarded as financially unfit and ineligible to serve as a designated broker if he/she:

- Has $100,000, or more, in tax liens against him/her
- Has a history of unpaid debt for during the three years prior to his/her application

Professional Standards for Loan Originators (WAC 208-660-350)
Criminal background checks are the first step in making certain that loan originators are professionals. The Department of Financial Institutions will not issue a license to an individual who has ever been: convicted of a felony involving an act of fraud, dishonesty, breach of trust, or money laundering; or has been convicted of a gross misdemeanor involving dishonesty or financial misconduct, or a felony not involving fraud, dishonesty, breach of trust, or money laundering, within the seven years prior to filing an application for a license.

Another basis for denial of a license application is the occurrence of any license suspension or revocation in Washington or in any other state that has a licensing law that is similar to the MBPA. Suspensions or license revocations prior to filing the license application will result in a denial of the application.
Education Requirements for Loan Originators (WAC 208-660-355)
As previously noted the S.A.F.E. Act and Washington’s Department of Financial Institutions establishes initial and continuing education and testing requirements to ensure that loan originators have knowledge of legislative and regulatory laws that impact mortgage lending. As a result of the minimum educational standards established by the S.A.F.E. Act, those seeking licenses as Washington loan originators must complete 20 hours of pre-licensing education (including 2 hours of Washington Law) and pass the National and Washington State tests developed by NMLS. (WAC 208-660-360)

Each year, in order to keep their licenses, loan originators must complete at least nine hours of continuing education. The requirement includes three hours on federal laws and regulations, two hours on ethics (including fraud, consumer protection, and fair lending), two hours on nontraditional mortgage products, and one hour of Washington Law.

Failure to complete continuing education courses will prevent the loan originator from renewing his/her license. Loan originators have until February 28th following the expiration of their license to meet any education requirements they failed to meet prior to expiration. However, they cannot originate loans until the education requirement and license renewal is complete. Licensees and license applicants should consult the Department of Financial Institution’s regulations, which provide very useful information on meeting the continuing education requirements. (WAC 208-660-370)

Financial Requirements for Loan Originators (WAC 208-660-350)(2)(d))
An applicant is regarded as financially unfit and ineligible to serve as a loan originator if he/she:

- Has $100,000, or more, in tax liens against him/her
- Has a history of unpaid debt for during the three years prior to his/her application

Accountability
Statutory and regulatory controls for mortgage brokers and loan originators have resulted from the harmful actions of a few bad players who have exploited the profession. Of particular concern in mortgage brokering are the careless and fraudulent practices of mortgage brokers and loan originators who make bad loans before moving on to originate fraudulent mortgage loans from other locations. Unable to locate them, neither the regulatory nor the legal system was able to hold these originators accountable for their negligent or unscrupulous actions.

The MBPA creates a number of requirements that seek to ensure that mortgage professionals licensed in the State of Washington are held accountable for their actions. The three most important tools for ensuring accountability are:

- Requiring licensees with out-of-state offices to appoint an agent for service of process
- Requiring mortgage brokers to appoint a designated broker
- Making licensees liable for the actions of the loan originators whom they employ
Registered Agent (RCW 19.146.260)
A registered agent is an individual or a business that accepts legal notices, such as a summons or a complaint, at a street address and not at a post office box. The registered agent can be a service that charges an annual fee to act as a registered agent, or an officer, owner or employee of the licensee.

The MBPA provides that every licensed mortgage broker that does not have a physical office in the State of Washington must maintain a registered agent within the state. A registered agent is optional for mortgage brokers who maintain an office in the State of Washington.

Licensees’ Responsibility for the Actions of Employees (RCW 19.146.085)
The MBPA specifically provides that mortgage brokers are liable for the acts of any designated broker, loan originator, or other employees. The law also provides that a designated mortgage broker is responsible for any violations of the law committed by a loan originator, employee or an independent contractor if: (RCW 19.146.200)

- The designated broker had knowledge of and approved the conduct that was in violation of the law
- The designated broker knew, or with the exercise of reasonable care, should have known of the conduct that was in violation of the law and failed to take reasonable remedial action

Supervision of Branch Offices (WAC 208-660-195)
Mortgage brokers are permitted to operate branch offices in Washington. Close supervision of branch offices is important because the mortgage broker is responsible for any violations of the law that occur in a branch office. Although brokers are responsible for the activities in branch offices, neither the law nor the rules specify how the supervision will take place. For example, there is no requirement to name a designated broker or a branch supervisor for the branch offices. The law does create the following requirements for branch offices:

- Prominent display of the branch office license
- Prominent identification of the office as a branch office in order to eliminate the impression that the office is an independent enterprise
- A surety bond that is sufficient to cover all of the loan originators working in the branch office
- Annual license renewal and payment of fees

Ability to Assume Liability (WAC 208-660-175)
In Washington, as in many states, mortgage brokers may not become licensed unless their application includes proof that they have obtained a surety bond. The purpose of surety bonds is to ensure that licensees have access to funds that they can use to compensate consumers for any losses suffered as a result of negligent origination or lending practices.

Washington law provides that the Department of Financial Institutions, consumers, and third party settlement service providers have a right of action under a surety bond. However,
borrowers have priority over all other parties that bring an action against a surety bond, and their claims must be satisfied before those of others. The statute of limitations for bringing an action against a bond is one year after the date of the violation that gives rise to a claim.

A surety bond is not insurance. If a surety pays money to cover a claim, the licensee must reimburse the surety company. If the licensee fails to repay the amount drawn against the surety bond, the surety can cancel the bond. Unable to conduct business as a mortgage broker without a bond, the licensee is motivated to comply with its legal obligations and to avoid claims against the bond. The law requires bonds in an amount that will vary, depending on the annual loan origination volume of the licensee.

The law provides that if the Director of the Department of Financial Regulation determines that a bond is not “reasonably available,” the bond requirement is waived. A mortgage recovery fund account is created to collect funds that will be used for the same purposes as a surety bond. However, only the Department can authorize payments from the account and a person cannot receive payment for the account unless a court finds evidence that a licensee caused damages. (WAC 208-660-176)

**Responsibility for Clients’ Funds (WAC 208-660-410)**

The MBPA requires the placement of all trust funds in a trust account in a federally insured financial institution located in the State of Washington, within three business days of receiving the funds. Trust funds include:

- Funds received from borrowers to pay for third party settlement services
- Fees for lock-in agreements

Licensees must disclose the existence of the trust fund to the state, and authorize the Department of Financial Institutions to examine it by filing “Notice of Clients’ Trust Account” and “Certificate of Compliance and Authorization to Examine Trust Accounts” forms. The forms are available online at the Department’s website.

If a licensee does not accept funds prior to closing, it is not necessary to establish a trust fund. However, the licensee is required to provide notice to the state that no trust fund exists and verify that neither the licensee nor its employees receives any funds from the borrower or third party settlement service providers. Licensees that do not maintain trust funds must file the “Washington Mortgage Broker Trust Monies Alternate Certificate of Compliance” with the Department of Financial Institutions. This form is also available online.

In addition to licensees, persons making or acquiring residential mortgage loans with their own funds are required to maintain trust accounts.

**Compliance Concerns after Obtaining an Initial License**

Compliance with the requirements of the MBPA is a constant concern for mortgage professionals. With licenses expiring annually, one of the ongoing concerns for brokers and
originators is license renewal. In addition to maintaining a current license, mortgage brokers and loan originators must take steps to ensure that they meet notice requirements, recordkeeping requirements, trust fund requirements, and advertising restrictions.

Requirements for License Renewal

As mentioned, licenses for mortgage brokers and loan originators must be renewed annually. Failure to renew a license in a timely manner will result in expiration of the license, and the licensee must apply for a new license. Following is an outline of the requirements for renewing licenses.

License Renewal Requirements for Mortgage Brokers (WAC 208-660-163(15); NMLS website)

Mortgage brokers must complete each of the following requirements in order to renew a license:

- Continue to meet the minimum standards for license issuance.6
- File the Mortgage Broker Annual Report, which is due on March 31st of each year, stating the number and the total dollar amount of residential mortgage loans secured by Washington real estate and originated and closed during the prior calendar year (WAC 208-660-400(1))
- Show that the designated mortgage broker has completed his/her education requirements. The designated mortgage broker must complete nine hours of continuing education each year. The department will accept the continuing education courses approved by the NMLS. (WAC 208-660-270(2)(a))
- Verify that the surety bond is adequate for the number of loan originators employed (WAC 208-660-175(1)(c))
- Pay the annual assessment fee (renewal fee) of $530, in addition to the applicable NMLS fee (WAC 208-660-550(1))
- Pay the annual assessment fee for each branch of $530, in addition to the applicable NMLS fee (WAC 208-660-550(1))

The rules provide a grace period until February 28th for licensees that fail to complete the renewal process on time. The penalty for late renewal is payment of an additional 50% of the annual assessment ($265). Licensees are also prohibited from taking part in licensed activities, such as loan originations, during the grace period. Failure to complete the renewal requirements within the grace period will result in license expiration and will necessitate application for a new license. (WAC 208-660-163(16))

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Overview of Mortgage Industry Laws and Regulations in Washington State (V3.1)
License Renewal Requirements for Loan Originators (WAC 208-660-350(15); NMLS website)

Licenses for loan originators expire annually on December 31st. Loan originators must complete each of the following requirements in order to renew a license:

- Pay the annual assessment fee of $125
- Pay an annual assessment of $50 for association with additional mortgage brokers (WAC 208-660-550(2))
- Meet the minimum continuing education requirement of eight hours to satisfy the federal requirement, plus at least one additional hour of Washington law for a total of nine hours (WAC 208-660-370(1))

Like mortgage brokers, loan originators have a grace period until February 28th. The penalty for late renewal is payment of an additional 50% of the annual assessment ($62.50). Licensees are also prohibited from taking part in licensed activities, such as loan originations, during the grace period. Failure to complete the renewal requirements within the grace period will result in license expiration and will necessitate application for a new license. (WAC 208-660-350(16))

Notice Requirements (WAC 208-660-400)

Although the deadlines for notice requirements are discussed in other sections of the course, the following list provides a summary of the time limitations for providing requisite notices to the state. These deadlines are also set forth in WAC Section 208-660-400. The Department of Financial Institutions has created forms for use in satisfying many of the following notification requirements. Licensees can access forms and download them from the DFI website. 7

Some of the deadlines are computed by counting “business days” instead of calendar days. The revised regulations define the term “business day” to mean “…Monday through Friday excluding federally recognized bank holidays.” (WAC 208-660-006)

Five Business Days’ Notice

Mortgage brokers must provide the Department of Financial Institutions with notice within five business days of the following events:

- A change in the location of the physical address of a mortgage broker’s books and records (WAC 208-660-400(8))
- Loss or change of a designated broker, using the form available online (WAC 208-660-400(9)) The designated mortgage broker means a natural person designated as the person responsible for activities of the licensed mortgage broker in conducting the business of a mortgage broker and who meets the experience and examination requirements set forth in RCW 19.146.210 (1)(e) and RCW 19.146.210(1)(3). The designated broker has at least two years of experience in the residential mortgage loan industry and has passed a written examination whose content shall be established by rule of the director. (WAC 208-660-006)

7 http://www.dfi.wa.gov/cs/mortgage_forms.htm
- Change in the status, location, account number, or other change relating to a trust account (WAC 208-660-400(13))

**Ten (Calendar) Days’ Notice** (WAC 208-660-400(7)(b))
Mortgage brokers must provide the Department of Financial Institutions with notice within ten days of the following events:

- Change in mailing address, telephone number, fax number, or email address
- Change in a Washington Master Business License
- Change in standing with the Washington Secretary of State (for example, a change in status as a corporation)
- Change in standing, including the resignation or change of the registered agent
- Receipt of notice of a cancelled bond
- Receipt of notice of license revocation
- Conviction of a felony, or a misdemeanor involving lending, brokering, or financial misconduct

**Ten Business Days’ Notice (Bankruptcies)** (WAC 208-660-400(14)), (15), (17)
The Director must be notified within ten business days if a mortgage broker company files for bankruptcy or if a designated broker or a loan originator files for personal bankruptcy.

**Ten Business Days’ Notice (Convictions)** (WAC 208-660–400(20)), (21)
Ten-business-day notice requirements are also triggered when a licensee is convicted for a felony or a gross misdemeanor or is the subject of an administrative enforcement action. Mortgage brokers, designated brokers, and loan originators must provide the Department of Financial Institutions with notice within ten business days after they are:

- Charged with or convicted of a felony or a gross misdemeanor involving dishonesty or financial misconduct in any jurisdiction
- Convicted outside of the State of Washington for a crime that would constitute a felony or a gross misdemeanor involving dishonesty or financial misconduct in Washington
- Charged with violations by an administrative authority (e.g. the Department of Financial Institutions) in any jurisdiction
- Subject to an administrative action such as a proceeding for license revocation, in any jurisdiction
- Convicted of any felony involving fraud, dishonesty, breach of trust, or money laundering in any jurisdiction

**Twenty Days’ Notice** (WAC 208-660-400(12)), (WAC 208-660-400(7)(c))
Mortgage brokers must notify the Department of Financial Institutions within 20 days after any of the following:

- Ceasing to do business in the state. A surrender must be filed through the NMLS and the mortgage broker annual report must be filed with the Department.
- Filing of a felony indictment
- Receipt of notice of filing of material litigation against the licensee
- Change in residential address or phone number

**Twenty Days’ Prior Notice** (WAC 208-660-400(7)(a))
The MBPA requires notice to the Department of Financial Institutions 20 days prior to a change in:
- Principal place of business or branch office
- Name or legal status
- Legal or trade name
- Ownership control of 10% or more

**Thirty to Thirty-one Days’ Prior Notice**
The MBPA requires notice to the Department of Financial Institutions prior to the occurrence of the following events:
- 31 days prior to resignation as a registered agent, the agent must notify the Department with a letter of resignation and must provide a copy of the letter to the mortgage broker that uses the registered agent’s services (WAC 208-660-400(10))
- 30 days prior to selling a mortgage business, the mortgage broker must notify the Department (WAC 208-660-400(11)(a))

**Annual Notice** (WAC 208-660-400(1), (2), (3), (4))
Every year, mortgage brokers must provide the Department of Financial Institutions with a report on mortgage broker activity in the State of Washington. The report provides the Department with information on:
- The total number of residential mortgage loans secured by Washington real estate that the mortgage broker originated and closed
- The total dollar volume (principal loan amounts) of the residential mortgage loans secured by Washington real estate that the mortgage broker originated and closed

The annual report is due on March 31st each year and covers brokering activities from January 1st to December 31st of the prior year. If a licensee fails to file an annual report within 30 days after it is due, the Department of Financial Institutions can bring an enforcement action. As noted in the section on license renewal, the filing of an annual report is a requisite step in renewing a license.

**Recordkeeping Requirements** (WAC 208-660-450)
Licensees must retain records for a period of 25 months, although the rules specifically state that “It may be a prudent business practice to keep your books and records longer than twenty-five months.” (WAC 208-660-450(3)(b)) Licensees may store records electronically if they are in a format that cannot be rewritten or erased. However, if the Department of Financial Institutions
requests a hard copy of the records, the licensee must provide it. Records must include: (WAC 208-660-450(1)(a))

- All forms of loan applications, written or electronic (the Fannie Mae 1003 is an example)
- The initial rate sheet or other supporting interest rate information
- The last rate sheet, or other supporting interest rate information, if there was a change in rates, terms, or conditions prior to settlement
- All written disclosures required by the MBPA and federal laws and regulations. Some examples of federal law disclosures are:
  - Good Faith Estimate
  - Truth-in-Lending disclosures
  - Equal Credit Opportunity Act disclosures
  - Affiliated business arrangement disclosures
  - RESPA servicing disclosure statements
- Documents and records of compensation paid to employees and independent contractors
- An accounting of all funds received in connection with loans, including a trust account statement with supporting data
- Rate lock agreements and the supporting rate sheets or other rate supporting document
- Settlement statements (the final HUD-1 or HUD-1A)
- Broker loan document requests (may also be known as loan document requests or demand statements) that include any prepayment penalties, terms, fees, rates, yield spread premium, loan type and terms
- Records of any fees refunded to applicants for loans that did not close
- All file correspondence and logs
- All mortgage broker contracts with lenders and all other correspondence with the lenders

In addition to loan documents, licensees must keep copies of the following:

- Advertisements, in any form, that include rates and fees (WAC 208-660-450(1)(b))
- Trust account records (WAC 208-660-450(1)(c))
- Documents that relate to the mortgage broker’s business such as policy and procedure manuals, training materials, and correspondence relating to complaints by consumers (WAC 208-660-450(1)(d))

A real estate broker that also acts as a mortgage broker is required to keep its records relating to mortgage broker business records separate and apart from its records relating to the real estate broker business.
Advertising Restrictions (WAC 208-660-440)

The list of prohibited practices that is contained in the MBPA includes a prohibition against advertising an interest rate without conspicuously disclosing the annual percentage rate (APR). The rules explain that the requirement for a conspicuous disclosure of the APR means that the APR must be the same size or larger than any other rates stated in the advertisement. This rule and the other rules relating to advertising are intended to protect consumers from deceptive or misleading advertisements. (WAC 208-660-440(4))

Generally, these rules prohibit the use of any emblems, stationery, or business names that misrepresent the type of lending institution that is advertising mortgage products. For example, a mortgage broker cannot create an advertisement that suggests that it is a federally-insured lending institution such as a bank or a government agency. The rules also prohibit advertising rates that are not actually available and claims to offer the “lowest” or “best” rates. (WAC 208-660-440(2), (7))

Mortgage brokers are responsible for the accuracy and legality of their advertisements. Deceptive or misleading advertisements can lead to liability under the MBPA or Washington’s Consumer Protection Act. Prior to releasing an advertisement, Washington mortgage brokers should make certain that their ads do not violate the MBPA, the federal Truth-in-Lending Act, or Regulation Z. Unintentional violations are easy to commit. The Federal Trade Commission has created a website to help those who are advertising credit terms. The site provides examples of common advertising errors and compliance issues. (WAC 208-660-440(1))

Disclosure Requirements

One of the primary concerns for licensees is complying with disclosure requirements. As the professionals that interact directly with borrowers, mortgage brokers and loan originators are responsible for providing disclosures required by both federal and state law. Federal and state disclosures are intended to:

- Educate consumers
- Provide consumers with information on loan costs
- Notify consumers of risky lending terms
- Notify consumers of their rights under federal lending laws
- Ensure that consumers know the status of their loan applications
- Give notice to consumers about changes in the servicing of their loans

The scope of this course will not cover federal disclosures in detail. However, licensees must be sure to observe the disclosure requirements of federal laws and regulations such as:

- Real Estate Settlement Procedures Act (RESPA) and Regulation X
- Truth-in-Lending Act (TILA) and Regulation Z

8 http://www.ftc.gov/bcp/edu/pubs/consumer/alerts/alt023.shtm
- Home Ownership and Equity Protection Act (HOEPA)
- Equal Credit Opportunity Act (ECOA) and Regulation B
- Fair and Accurate Credit Transactions Act (FACTA)
- Homeowners Protection Act (HPA)

**State-Required Disclosures (RCW 19.146.030)**

In addition to federal disclosures, the MBPA creates some additional disclosures to provide further protection to consumers. These disclosure requirements are outlined below in the next sections.

**Written Disclosure of Fees and Costs**

Within three business days after the receipt of a loan application, the MBPA requires the mortgage broker or a loan originator to provide a disclosure that gives the loan applicant the following information:

- The annual percentage rate, finance charge, amount financed, total amount of all payments, number of payments, amount of each payment, amount of points or prepaid interest and the conditions and terms for changes in loan terms prior to closing. If a variable rate is involved, the potential rate increases and its impact must also be explained.
- An explanation of all fees and costs that a borrower will pay in order to obtain a loan (the Good Faith Estimate can satisfy this portion of the disclosure) including the fees that the mortgage broker will earn.
- Itemized costs for expenses such as credit report, appraisal, title report, title insurance policy, mortgage insurance escrow fee, property tax, insurance and any other third-party provider’s costs.
- A statement that the mortgage broker cannot charge fees for his/her/its services in excess of the amount disclosed in the Good Faith Estimate unless the need for an additional charge was not foreseeable at the time of the initial disclosure and if the mortgage broker has provided a written explanation of the fee within three business days prior to closing.
- A statement that any money the loan applicant advances to the mortgage broker will be held in trust for the payment of third party settlement services.
- A statement advising the loan applicant that if he/she does not obtain a loan, he/she can make a written request for copies of the appraisal, title report, or credit report and receive these documents within **five days**.
- A rate lock agreement and disclosure form, if applicable. This must include the cost, terms, duration, and conditions of the rate lock agreement.

The Department of Financial Institutions has created a model form for use in satisfying this disclosure requirement, and it is available online.  

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Overview of Mortgage Industry Laws and Regulations in Washington State (V3.1)

One Page Disclosure Summary (RCW 19.144.020)
Licensees under the MBPA should note that they must comply with the requirement created under Washington’s predatory lending law, to provide a one-page disclosure summary to all loan applicants within three business days after receipt of an application. This requirement is discussed at greater length in a subsequent section of this course that reviews the CLA and the state’s predatory lending law.

Disclosure by Real Estate Brokers that Originate Loans (WAC 208-660-300(7))
In Washington, a real estate broker may also serve as a loan originator. The MBPA creates a special disclosure requirement that is intended to inform loan applicants that they have a choice in the selection of the lender, broker, or other loan originator. The notice must state:

THIS IS TO GIVE YOU NOTICE THAT I OR ONE OF MY ASSOCIATES HAVE/HAS ACTED AS A REAL ESTATE BROKER OR SALESPERSON REPRESENTING THE BUYER/SELLER IN THE SALE OF THIS PROPERTY TO YOU. I AM ALSO A LOAN ORIGINATOR, AND WOULD LIKE TO PROVIDE MORTGAGE SERVICES TO YOU IN CONNECTION WITH YOUR LOAN TO PURCHASE THE PROPERTY.

YOU ARE NOT REQUIRED TO USE ME AS A LOAN ORIGINATOR IN CONNECTION WITH THIS TRANSACTION. YOU ARE FREE TO COMPARISON SHOP WITH OTHER MORTGAGE BROKERS AND LENDERS, AND TO SELECT ANY MORTGAGE BROKER OR LENDER OF YOUR CHOOSING.

Discussion Scenario: Failure to Meet Disclosure Requirements

Disclosure requirements are an important component of conducting business in the mortgage industry. Failing to provide proper disclosures in the course of a loan transaction is a consumer protection issue and places mortgage professionals at risk for civil and criminal action. What if this risk cost you license revocation and administrative penalties?

There are numerous provisions under Washington law requiring proper disclosure. Some disclosure requirements (such as the Good Faith Estimate of loan costs and Truth-in-Lending disclosures) are similar to federal requirements. Others are broader than federal requirements and some are unique to Washington. Written disclosure of all fees and costs, the one-page disclosure summary, and the dual capacity disclosure are just a few specifically addressed under Washington law.

To illustrate the importance of proper disclosure, consider the fate of a mortgage loan finance company which faced with steep fines in 2010 for failure to provide disclosures to consumers. The broker, which had ceased business in 2009 and surrendered its license, became the focus of an investigation by the Washington Attorney General. Through the investigation it was discovered that nearly every loan file reviewed was missing disclosures and/or contained incomplete documents.
Discussion Questions:

Why do state and federal laws mandate disclosures?

Based on the state requirements we have reviewed so far, what impact could the missing and incomplete documents have had on the borrowers involved?

What do you think could have led the finance company to fail to meet disclosure requirements on such a great scale?

In addition to Washington law, what are some federal laws that may have been violated?

Discussion Feedback
State and federal disclosure requirements have a number of purposes. Some ensure that a consumer is advised on fees and charges (the “cost of credit”) and the terms of their loan. This allows consumers to make an educated decision before entering into a loan transaction – often the biggest investment they will make in their lives. Other disclosures advise them of their rights and their obligations as a party to the transaction. In addition to state requirements, federal mortgage-related laws include specific disclosure provisions; the Truth-in-Lending Act (TILA), the Real Estate Settlement Procedures Act (RESPA) and the Equal Credit Opportunity Act (ECOA) are just a few.

When consumers are not provided with appropriate disclosures on mortgage transactions, they may make decisions without knowing all of the facts. Poor decisions can result in debt problems, default and foreclosure, and places the lien holder’s investment in jeopardy. Failing to meet disclosure requirements on a large scale is a sign that the mortgage broker was either unaware of the disclosure obligations or was simply not committed to good business practices. Another possibility is that the broker failed to disclose in order to hide unprofessional or unethical business practices such as charging illegal fees, etc.

Failure to Meet Disclosure Requirements: The Potential Outcome

Following the investigation, the Attorney General filed a lawsuit against the finance company charging it with violations of the federal Real Estate Settlement Procedures Act (RESPA), Truth-in-Lending Act, RCW 19.144.020, RCW 19.146.030, and WAC 208-660-300. The lawsuit asked the court to prohibit the company from committing further violations, require the company to make restitution to all the borrowers who had lost money due to the violations and to pay civil penalties. The company’s actions were also deemed unfair and deceptive trade practices under Washington’s Consumer Protection Act.

Discussion Questions:

What are some business practices a mortgage broker could put in place to ensure disclosure requirements are met?

How would you react if you were one of the borrowers harmed by the mortgage broker’s actions?
Discussion Feedback
Education and research on state and federal disclosure requirements is the first step in ensuring mortgage professionals meet their obligations. Once those obligations have been determined, it is up to the business to set up policies and procedures that ensure the requirements are met on each and every transaction. Consistency, professionalism and full disclosure give consumers confidence in the services they are provided as part of a loan transaction.

Prohibited Practices (WAC 208-660-500(3))

The MBPA creates a list of prohibited practices. Mortgage brokers and loan originators should read Section 208-660-500 of the WAC to familiarize themselves with the specific business practices that the MBPA prohibits. The list is as follows:

- Directly or indirectly employing any scheme, device, or artifice to defraud or mislead borrowers or lenders or to defraud any person
- Engaging in any unfair or deceptive practice toward any person
- Obtaining property by fraud or misrepresentation
- Soliciting or entering into a contract with a borrower that provides in substance that the mortgage broker may earn a fee or commission through the mortgage broker's "best efforts" to obtain a loan even though no loan is actually obtained for the borrower
- Charging discount points on a loan which does not result in a reduction of the interest rate. Some examples of discount point misrepresentations are:
  - A mortgage broker or lender charging discount points on the good faith estimate or settlement statement payable to the mortgage broker or any party that is not the actual lender on the resident mortgage loan
  - Charging loan fees or mortgage broker fees that are represented to the borrower as discount points when such fees do not actually reduce the rate on the loan, or reflecting loan origination fees or mortgage broker fees as discount points
  - Charging discount points that are not mathematically determinable as the same direct reduction of the rate available to any two borrowers with the same program and underwriting characteristics on the same date of disclosure
  - Charging total fees in excess of usual and customary charges, or total fees that are not reasonable in light of the service provided when providing residential mortgage loan modification services
- Failing to clearly and conspicuously disclose whether a payment advertised or offered for a residential mortgage loan includes amounts for taxes, insurance, or other products sold to the borrower. This prohibition includes the practice of misrepresenting, either orally, in writing, or in any advertising materials, a loan payment that includes only principal and interest as a loan payment that includes principal, interest, tax, and insurance
- Failing to provide the exact pay-off amount of a loan you own or service as of a certain date five or fewer business days after being requested in writing to do so by a borrower of record or their authorized representative
- Failing to record a borrower's payment, on a loan you own or service, as received on the day it is delivered to any of the licensee's locations during its regular working hours
- Negligently making any false statement or willfully making any omission of material fact in connection with any application or any information filed by a licensee in connection with any application, examination or investigation conducted by the department
- Purchasing insurance on an asset secured by a loan without first attempting to contact the borrower by mailing one or more notices to the last known address of the borrower in order to verify that the asset is not otherwise insured
- Willfully filing a lien on property without a legal basis to do so
- Coercing, intimidating, or threatening borrowers in any way with the intent of forcing them to complete a loan transaction
- Failing to reconvey title to collateral, if any, within thirty days when the loan is paid in full unless conditions exist that make compliance unreasonable
- Failing to make disclosures to loan applicants and noninstitutional investors as required by RCW 19.146.030 and any other applicable state or federal law
- Making, in any manner, any false or deceptive statement or representation with regard to the rates, points, or other financing terms or conditions for a residential mortgage loan. An example is advertising a discounted rate without clearly and conspicuously disclosing in the advertisement the cost of the discount to the borrower and that the rate is discounted
- Engage in bait and switch advertising
- Engage in unfair or deceptive advertising practices. Unfair advertising may include advertising that offends public policy, or causes substantial injury to consumers or to competition in the marketplace
- Negligently making any false statement or knowingly and willfully make any omission of material fact in connection with any reports filed by a mortgage broker or in connection with any investigation conducted by the department
- Making any payment, directly or indirectly, to any appraiser of a property, for the purposes of influencing the independent judgment of the appraiser with respect to the value of the property
- Advertising a rate of interest without clearly and conspicuously disclosing the annual percentage rate implied by the rate of interest
- Failing to comply with the federal statutes and regulations in RCW 19.146.0201(11) (such as the federal Real Estate Settlement Procedures Act, Truth-in-Lending Act, Equal Credit Opportunity Act, or Gramm-Leach-Bliley Act)
- Failing to pay third-party providers within the applicable timelines
- Collecting or charging, or attempting to collect or charge, or use or propose any agreement purporting to collect or charge any fees prohibited by the Act
- Acting as a loan originator and real estate broker or salesperson, or acting as a loan originator in a manner that violates RCW 19.146.0201(14)
- Failing to comply with any provision of [the Mortgage Broker Practices Act] or any rule adopted under [it]
- Intentionally delay closing of a residential mortgage loan for the sole purpose of increasing interest, costs, fees, or charges payable by the borrower
- Steering a borrower to less favorable terms in order to increase the compensation paid to the company or mortgage loan originator
- Receiving compensation or any thing of value from any party for assisting in real estate “flopping”
- Abandoning records

Licensees who engage in any of the prohibited practices are subject to fines and to license suspension or revocation.

**Fiduciary Responsibility (RCW 19.146.095)**

The Washington Legislature passed a bill in 2008 providing that mortgage brokers have a fiduciary responsibility to borrowers. Whether mortgage brokers should function as fiduciaries is a question that mortgage professionals, consumer interest groups, and legislators have debated extensively. As a fiduciary, a mortgage broker must act in the best interest of each borrower, putting the interests of the borrower ahead of the interests of the broker.

The decision to create a fiduciary duty for mortgage brokers resulted in part from recommendations offered by a task force assembled by Governor Chris Gregoire. Presenting an argument in favor of regulatory reforms that might address some of the problems in the subprime lending market, the Task Force concluded:

> A fundamental component of reform is to require that lenders and mortgage brokers have fiduciary responsibility to their customers. Homeowners have suffered from misplacing their trust in the hands of the minority of mortgage brokers and lenders whose interest is maximizing their profits without regard to the consequences to their customers.10

The Task Force reasoned that the creation of a fiduciary relationship between mortgage brokers and borrowers is fair “…because brokers market their services with the claim that they have products that are in the best interest of homeowners and home buyers....”11

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11 Ibid.
The fiduciary duty that is now set forth in the MBPA requires licensees to:

- Act in the borrower’s best interests
- Refrain from accepting, providing, or charging any undisclosed compensation
- Carry out all lawful instructions of the borrower
- Disclose all material facts to the borrower that might affect the borrower’s rights and interests
- Use reasonable care in performing duties
- Provide an accounting to the borrower for all money and property received from the borrower

The law requires the disclosure of all fees by stating that a mortgage broker can collect a fee for services performed if the fee is disclosed prior to providing the services. With this provision, the law encourages communication between broker and borrower that will prevent misunderstandings and that will enable borrowers to come to the closing table with a better understanding of the costs of their loans.

**Authority of the Director of Financial Institutions**

Although licensing now takes place through the NMLS, it is not the NMLS that makes decisions on license applications. The Department of Financial Institutions still has authority to approve or deny license applications. In addition to its authority to grant or deny mortgage broker and loan originator licenses and to issue rules to carry out the purposes of the MBPA, the Department of Financial Institutions has the authority to conduct disciplinary actions, examine the records of licensees and the records of some exempt entities, and to conduct investigations. The extent of the agency’s authority in these areas is outlined below.

**Disciplinary Actions (RCW 19.146.220)**

The Department of Financial Institutions has the authority to suspend, revoke, or refuse to renew the license of a mortgage broker or loan originator for any of the following reasons:

- Violating orders issued by the Department
- Making false statements on a license application or renewal application
- Omitting material information from a license application or renewal application
- Violating the MBPA
- Failing to pay fees required by the Director of the Department of Financial Institutions
- Failure to maintain the requisite surety bond

The Department has the authority to issue injunctions and cease and desist orders in the following circumstances: (RCW 19.146.227)

- The public is likely to suffer substantial injury as a result in a delay in issuing a cease and desist order
- A person is taking part in an act or practice that is in violation of the MBPA

**Examinations and Investigations (WAC 208-660-510)**

The Department of Financial Institutions has the authority to conduct examinations on the business records and affairs of licensees. The Department will generally provide notice at least 30 days prior to the routine examination. The Department will not provide notice of “for cause” examinations (investigations), which take place when the Department has reason to suspect that violations of the law are occurring.

When routine examinations are conducted in-state, the licensee is not required to pay the costs of the examination. If the examination takes place out-of-state, the licensee must pay for the examiner’s costs of transportation, meals, and lodging. The Department has the option of using an independent certified professional to conduct examinations.

The purpose of an investigation is to assess allegations that a licensee is violating the law and to determine if an enforcement action is necessary. The Department is not required to provide advance notice of an investigation, although it may do so in some circumstances. The Department may charge the licensee for the cost of conducting an investigation. The current rules provide that the fee for an examiner who is conducting an investigation is $48 per hour. The Department will also charge the licensee for the cost of attorneys, accountants and other professionals who are hired to assist in an investigation.

**Violations of the MBPA (WAC 208-660-530)**

Violations of the MBPA can result in an administrative action by the Director of the Department of Financial Institutions. The Department may make referrals for civil or criminal actions to Washington’s Attorney General or to federal authorities. The Department can also impose fines of up to $100 for each day that a violation of the law continues. (WAC 208-660-530(3)), (6)

A violation of the laws and rules relating to trust fund accounts is a Class C felony and may result in up to five years in prison and/or a fine of $10,000. Interference with an investigation by the Department by withholding, destroying, removing, or hiding any books, records, computer data or other information is considered a Class B felony. These actions may result in a penalty of up to ten years in prison and/or a fine of $20,000. (WAC 208-660-530)(10))

The Mortgage Broker Protection Act states that any violation of its provisions is also a violation of the state’s Consumer Protection Act. Therefore, any consumer who is injured as a result of illegal mortgage lending practices can also claim to be the victim of an unfair or deceptive trade practice and bring an action under the Consumer Protection Act.

**Mortgage Professionals and Loans Regulated Under the CLA**

As discussed in the review of the MBPA, mortgage professionals who are licensed under that Act are no longer allowed to make (fund) loans without additional licensing under the Consumer Loan Act. Prior to the 2008 legislative session, only those who wanted to make loans at interest
rates that exceed rates allowed under Washington’s usury statute were required to obtain a license under the CLA. Now, and as a result of Senate Bill 6471, which was adopted in 2008, mortgage professionals who want to function as lenders must obtain a license under the CLA, regardless of the interest rate for the loan.

In 2009, the Washington State Legislature passed legislation that was intended to resolve some of the confusion created by Senate Bill 6471. The most pressing issues were:

- Clarifying the types of mortgage professionals regulated under the CLA
- Creating regulatory requirements for loan originators who are employed by CLA licensees
- Ensuring that the CLA meets the legislative standards established under the S.A.F.E. Act

With its enactment of House Bill 1621, the Legislature achieved its objectives. The following sections will review the requirements of the revised Consumer Loan Act.

**Lending Activities, Mortgage Professionals, and Loans Regulated by the CLA**

Washington’s CLA defines the statutory requirements for obtaining a license as a loan originator employed by a consumer loan company. In order to be able to identify the types of mortgage professionals and loans that are subject to the requirements of the CLA, it is necessary to understand the definitions that the law gives to the following terms: (RCW 31.04.015(12)

**Loan:** Open and closed-end transactions for lending money with charges for interest or fees

**Making a Loan:** Closing a loan in a person’s name, or advancing, offering to advance, or making a commitment to advance funds to a borrower for a loan

**Mortgage Loan Originator:** A person employed, either directly or indirectly, or retained as an independent contractor by a licensee, to make or assist a person in applying to obtain a loan

**Residential Mortgage Loan:** A loan primarily for personal, family, or household use that is secured by a mortgage on a dwelling

**Exemptions**

The requirements of the CLA do not apply to the following entities: (RCW 31.04.025)

- **Real Estate Brokers:** Entities or individuals that are licensed in the state as real estate brokers are exempt from the requirements of the CLA unless they are compensated by a lender, broker, or other mortgage loan originator.

- **Timeshare Creditors:** Entities that are solely involved in extending credit for timeshare plans are exempt from the requirements of the CLA.
- **Federal or State-Regulated Depository Institutions**: Banks, savings banks, trust companies, savings and loan or buildings and loan associations are exempt from the requirements of the CLA.

- **Entities Regulated Under Other State Laws**: Pawn brokers, retail lenders, and check cashers are exempt from the requirements of the CLA.

- **Commercial, Business, and Agricultural Lenders**

- **Entities Making Loans under the Housing Trust Fund**

- **Lenders Making Loans Under Federal Programs**: Entities that make loans under federal government programs such as those offered by the Department of Housing and Urban Development are exempt from the requirements of the CLA.

The CLA does not apply to the following individuals: (WAC 208-620-105)

- **Registered Loan Originators**: Individuals who work for depository institutions as loan originators/employees and who are registered with the NMLS are exempt from the requirements of the CLA.

- **Individuals Negotiating a Loan**: The law exempts individuals who offer or negotiate terms for a mortgage loan with or on behalf of an immediate family member. Immediate family members include spouse, children (including unborn children), step-children, foster children, or parents of either spouse, whether living with you or not, and other relatives who temporarily or permanently reside in your household.

- **Licensed Attorneys**: The law exempts a licensed attorney who negotiates the terms of a mortgage loan on behalf of a client, as an ancillary matter to the attorney’s representation of the client unless the attorney earns compensation from a mortgage lender, mortgage broker, or loan originator.

- **Loan Processors**: Loan processors and other individuals that perform purely clerical or administrative tasks such as receiving, collecting, and distributing information related to a mortgage application are exempt from the requirements of the CLA.

### CLA Licensing Requirements for Loan Companies

The requirements for obtaining a license to operate a business that makes loans are essentially the same as the requirements to obtain a mortgage broker license under the MBPA. Like licensing for mortgage brokers, licensing for consumer loan companies involves submission of applications to the NMLS and the satisfaction of jurisdiction-specific requirements through the Department of Financial Institutions.

#### Submitting Applications to the NMLS (WAC 208-620-280)

The license applicant must complete an MU1 form and submit it to the NMLS. The CLA requires each of the following individuals to provide the biographical information that is requested on the MU2 form:

- Officers
Directors

Owners

These individuals must also provide fingerprints for a criminal background check.

**Surety Bond Requirements (WAC 208-620-320)**

Applicants for a consumer loan license must obtain a surety bond for at least $30,000. The exact amount of the bond must be based on the annual amount of loans originated. In lieu of a surety bond, an applicant that is a Washington business corporations can show that its debt does not exceed three times the aggregated amount of its: (WAC 208-620-340)

- Unimpaired capital
- Surplus
- Unsubordinated long-term debt

The statute allows the Department of Financial Institutions to define qualifying long-term unsubordinated debt. Generally, long-term debt is an obligation, such as a mortgage loan, with a maturity of more than one year. Unsubordinated debt is debt that a borrower must pay before he/she pays other debts, liens, and obligations that are owed.

After obtaining a license, consumer loan companies must complete annual renewal applications before their licenses expire on December 31st. In order to successfully renew their licenses, consumer loan companies, like mortgage brokers, must be prepared to show continued maintenance of a surety bond, completion of education requirements, and proof they have filed an annual report. However, consumer loan companies must file their annual reports on March 1st, not on the last day of the month as mortgage brokers are required to do. (WAC 208-620-710(17),(18)

**Fees and Interest Rate Limitations Under the CLA**

The CLA allows licensees to charge fees and interest rates in mortgage lending transactions as long as they comply with the limits that are created by the law. CLA licensees can charge fees and interest as described below:

**Fee Limit for Licensees Serving As Brokers:** Licensees under the CLA can function as a lender or as a broker. A licensee that makes a loan while serving as a broker and as a lender in the same transaction is prohibited from receiving compensation for brokering the loan and additional compensation for funding it. In other words, a licensee can earn compensation as a lender or as a broker, but not as both. (RCW 31.04.015(14))

**Mortgage Broker Fee:** If a borrower obtains a loan, mortgage brokers can charge a fee for their services as long as they are not owned by or under common ownership with the consumer loan company that makes the loan. Once again, the purpose of this rule is to prevent a licensee from earning double fees. (WAC 208-620-555)(3))
**Third Party Settlement Services:** Licensees can charge borrowers for the services of third parties such as appraisers, credit reporting agencies, title companies, and escrow companies. However, licensees can only collect charges for appraisers if a loan is made. (WAC 208-620-555(4))

**Interest Rate Limit:** The original purpose of the CLA was to make credit available to borrowers who represent a high risk to lenders. Loans made under the CLA are exempt from the state usury law, which essentially limits interest rates to 12%. Under the CLA, the legislature authorizes interest rates of up to 25%. The interest rate on a loan cannot exceed 25% per year as determined by the simple interest method of calculating interest owed. (WAC 208-620-235)

**Simple Interest Method of Calculating Interest** (RCW 31.04.015(28))
The CLA clearly states that interest may not be calculated via any method that results in compounding interest. (Compounding interest is interest charged on the interest accrued against a loan’s remaining principal.) Instead, interest due must be calculated using the simple interest method. The goal of this requirement is to ensure that loans made under the CLA are not made more expensive due to compounding interest.

The CLA defines “simple interest method” as the method of calculating the interest payable on a loan by applying the annual percentage interest rate (or its periodic equivalent) to the unpaid balance of the outstanding principal for the for the time remaining on the loan term. Furthermore, each payment must be applied, as follows:

- First to any unpaid penalties, fee or charges
- Then to accumulated interest
- The remainder of the payment is applied to the unpaid balance of the principal until paid in full

The formula for finding simple interest is:

\[
\text{Simple Interest} = \text{Loan Principal} \times \text{Interest Rate} \times \text{Time Span}
\]

Within its definition of “simple interest method,” the CLA states: “In using such method, interest must not be payable in advance nor compounded....” There is one exception to the rule against prepaid interest. When a loan is secured by real estate, the licensee can collect, at the time of closing, an amount that is up to, but not in excess of, 45 days of prepaid interest.

**CLA Disclosure Requirements** (RCW 31.04.102)
The CLA states that within three business days after the receipt of an application for a loan secured by real property, a licensee must provide a written disclosure to each borrower that states an estimated annual percentage rate (APR) and costs associated with the transaction. This requirement is identical to the requirements under the Truth-in-Lending Act and the Real Estate Settlement Procedures Act, and compliance with these provisions will constitute compliance with state law.
Licensees under the CLA must also comply with the provision under the state’s predatory lending law that requires lenders and brokers to provide a one-page disclosure summary, within three business days after receipt of a loan application. The disclosure must contain, in simple English, information on all of the following terms, if applicable: (RCW 19.144.020)

- Fees and discount points
- Interest rates
- Broker fees
- Prepayment penalties
- Balloon payment
- Statement indicating whether property taxes and property insurance are escrowed
- Statement indicating whether the loan payments will adjust at the fully indexed rates
- Statement indicating whether there is a price added or premium charged because the loan is based on reduced documentation

The DFI has created a model form for this disclosure, and it is available online. ¹²

**Licensing Requirements for Mortgage Loan Originators**

In order to work as a loan originator for a consumer loan company, an individual must obtain a loan originator license under the CLA and renew it annually. Like loan originators licensed under the MBPA, the applicant must meet pre-licensing education requirement of 20 hours and continuing education requirements of nine hours. Applicants must file an MU4 form, providing the information that the Department of Financial Institutions needs to assess their professional, ethical, and financial fitness. (RCW 31.04.261), (.264), (.267)

The issues that the Department will consider in determining whether to issue a loan originator license under the CLA are the same as those that it considers when issuing a license under the MBPA.

**Prohibited Practices (WAC 208-620-550)**

Like the MBPA, the CLA has a list of prohibited practices, which constitute unfair or deceptive acts or practices:

- **Disclosure of payoff amount:** Failure to provide the exact pay-off amount as of a certain date within five business days after being requested in writing to do so by a borrower of record or their authorized representative
- **Recognition of payment delivery:** Failure to record a borrower's payment as received on the day it is delivered to any of the licensee's locations during its regular working hours

- **Charging a fee for best efforts:** Soliciting or entering into a contract with a borrower that provides in substance that the licensee may earn a fee or commission through its “best efforts” to obtain a loan even though no loan is actually obtained for the borrower.

- **Unfair or deceptive advertising:** Engaging in unfair or deceptive advertising practices. Unfair advertising may include advertising that offends public policy, or causes substantial injury to consumers or to competition in the marketplace.

- **False filing:** Negligently making any false statement or willfully making any omission of material fact in connection with any application or any information filed by a licensee in connection with any application, examination or investigation conducted by the department.

- **Influencing appraisers:** Making any payment, directly or indirectly, or withholding or threatening to withhold any payment, to any appraiser of a property, for the purposes of influencing the independent judgment of the appraiser with respect to the value of the property.

- **Documents with blanks:** Leaving blanks on a document that is signed by the borrower or providing the borrower with documents with blanks.

- **Inclusion of taxes and insurance:** Failing to clearly disclose to a borrower whether the payment advertised or offered for a real estate loan includes amounts for taxes, insurance or other products sold to the borrower.

- **Force placed insurance:** Purchasing insurance on an asset secured by a loan without first attempting to contact the borrower by mailing one or more notices to the last known address of the borrower, unless mail has been previously returned as undeliverable from the address, in order to verify that the asset is not otherwise insured.

- **Filing an inappropriate lien:** Willfully filing a lien on property without a legal basis to do so.

- **Threats and coercion:** Coercing, intimidating, or threatening borrowers in any way with the intent of forcing them to complete a loan transaction.

- **Title reconveyance:** Failing to reconvey title to collateral, if any, within thirty business days when the loan is paid in full unless conditions exist that make compliance unreasonable.

- **Delaying closing:** Intentionally delaying the closing of a residential mortgage loan for the sole purpose of increasing interest, costs, fees, or charges payable by the borrower.

- **Steering:** Steering a borrower to a residential mortgage loan with less favorable terms than they qualify for in order to increase the compensation paid to the company or mortgage loan originator.

- **Unique identifier:** Failing to indicate on all residential mortgage loan applications the company’s unique identifier, and the date the application was taken.

- **Flopping:** Receiving compensation or anything of value from any party for assisting in real estate “flopping.”
Issues addressed under the CLA that are not addressed by the MBPA include:

- Limitations on the interest that a lender can change on loans
- The method for calculating interest
- Requirements and restrictions for open-end transactions

**Discussion Scenario: The Case of Mortgage Fraud**

In early 2010, the Department of Financial Institutions (DFI) responded to consumer complaints and launched an investigation of a company called Frankfurt & Goldenrod Financial. The DFI determined that Frankfurt & Goldenrod was posing as a mortgage company for the purposes of identity theft. The company’s website advertised easy money and instant loan approval for consumers with damaged credit. The website also featured an online application where consumers were asked to provide personal information, social security numbers and financial account numbers. Following complaints, the regulator quickly ascertained that the company was not licensed under either the Mortgage Broker Practices Act or the Consumer Loan Act.

Along with the allegations of identity theft, a spokesperson for DFI reported that the company was soliciting advance fees for services and then providing nothing in return. For instance, one consumer reported being offered a 15-year loan of $25,000 but was required to wire a deposit of $2,100 for the first ten months’ payments and an additional $2,100 for the purposes of “mortgage insurance.” The consumer was then told the loan approval had fallen through and the funds would be returned to his bank account within a month – something that never occurred.

The investigation continues but it is likely a number of Washington consumers were victimized. The DFI has since issued a cease and desist order against the company and has referred the case to the Attorney General for further investigation and criminal prosecution. The DFI spokesperson indicated that the FBI Mortgage Fraud Unit has also been alerted to the proceedings.

**Discussion Questions**

- In addition to failing to become licensed under Washington law while representing to the public that it was a mortgage company, what other state (and federal laws) did Frankfurt & Goldenrod violate?
- What kind of impact do cases like this have on mortgage professionals who are operating legitimately?
- How would you handle a client who has heard about situations like this in the news? What steps would you take to educate them and ease their concerns?

**Discussion Feedback**

The company’s business practices in general appear to be a front for fraud and other criminal activities. Questionable acceptance of advance fees, lack of disclosure and other predatory practices are a clear violation of federal fraud laws, federal mortgage laws such as the Truth-in-Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA) and local and federal consumer protection laws. There is also no doubt that the actions of the company violated...
the prohibited practices provisions of the MBPA and the CLA as well as Washington’s Consumer Protection Act.

Companies that commit fraudulent acts put a black mark on the mortgage industry. By decreasing the public’s trust, they make it more difficult for companies and individuals who are operating ethically to conduct business. A customer who has a negative opinion of the industry based on incidents like this may need reassurance and increased communication during the course of their loan transaction.

Careful explanation of the origination process and proof that the mortgage professional is operating in compliance with the law would be necessary to ease the customer’s fears. Applying sound and consistent business practices and good communication to all customer transactions raises the bar increases consumer trust in the industry.

**Requirements and Restrictions on Open-end Transactions (RCW 31.04.115)**

An open-end loan is one that establishes a line of credit for the borrower, which he/she can use repeatedly until reaching the loan’s limit. After repaying the loan or any portion of it, the borrower can obtain advance of credit again. A home equity line of credit (HELOC) is an example of an open-end loan. Because these loans are typically secured with the borrower’s primary residence, there are a number of requirements that are intended to protect the borrower.

Washington law creates the following requirements for open-end loans:

- Borrowers can pay the account in full at any time with no prepayment penalty
- If the lender takes a security interest in the borrower’s real property, the security interest must be released if there has been no outstanding balance in the account for 12 months or if the account is terminated and paid in full
- The borrower can terminate the loan and repay the unpaid balance prior to the effective date of an increase in the interest rate on the loan
- The borrower must receive a copy of the loan agreement when the open-end account is created

The interest rate on these loans is limited to 25%, and the law specifies particular methods that loan companies must use for computing the interest charges for each billing cycle.

Loan companies that make open-end loans secured by a borrower’s principal dwelling should consider the impact of Washington’s new predatory lending law on expensive open-end loans. Unlike the federal law, the Home Ownership and Equity Protection Act (HOEPA), the Washington law does not limit its application to closed-end transactions. An open-end loan that meets the lending standards under the CLA may fail to meet the stricter underwriting standards and consumer protection provisions created by the new predatory lending law. Washington’s predatory lending law will be addressed in a subsequent section of this course.
Washington's Usury Law (RCW 19.52)

The Department of Financial Institutions defines usury as: “...the unlawful act of charging interest on a debt (including discount points, fees and other charges) at a rate greater than what is permitted under any applicable law or exemption from a law.”

The provisions of the law that apply to mortgage lending transactions provide that interest rates cannot exceed the higher of the following two numbers: (RCW 19.52.020(1))

- 12% per year
- Four percentage points above the Federal Reserve rate on 26-week Treasury bills

With the exception of interest rates on subprime loans originated by consumer loan companies, interest rates in recent times have not exceeded 12%. As the Department of Financial Institutions explains:

For many years, the Federal Reserve rate on 26-week Treasury bills has remained below 8%, so that Washington State’s maximum interest rate under the general usury law has effectively been 12%. If future economic conditions in the United States ever caused a radical shift in the government bond market so that the yield on treasury bills exceeded 8%, then the maximum interest rate permitted under RCW 19.52.020(1) would climb above 12%. This was certainly the case in the early 1980’s, when the yield on government bonds had soared so high that, for a brief time, interest rate on a consumer’s non-credit card and non-retail installment debt was permitted to legally exceed 21%! 14

Even if interest rates begin to climb significantly, and reach limits that are usurious under Washington law, there are endless legal questions concerning the applicability of the state usury law to home loans. Many of these questions relate to the preemption of state usury laws by federal laws.

In 1980, Congress enacted the Depository Institutions Deregulation and Monetary Control Act (DIDMCA), which eliminated some limitations on interest rates, and preempted certain provisions in state usury laws. One of the purposes of the law was to ensure that all Americans would have access to home loans, even if obtaining a mortgage meant that some Americans would have to pay much higher interest rates. As the Office of Thrift Supervision stated: “The purpose of this permanent preemption of state interest-rate ceilings...is to ensure that the availability of such loans is not impeded in states having restrictive interest limitations.” 15

DIDMCA preempts state usury laws for loans secured by a first lien on residential real property. Another federal law, the National Housing Act, preempts state usury limits for some junior lien loans. The impact of these and other federal laws has been to render most provisions of state usury laws ineffective in achieving their stated purpose of protecting citizens of the states

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14 Ibid.
15 54 FR 49715 30 Nov. 1989
“...from debts bearing burdensome interest rates.” (RCW 19.52.005) Some proposed responses to the subprime lending crisis have included repealing those provisions in federal laws that prevent states from enforcing their usury laws in mortgage lending transactions.

**Washington State Enacts Legislation to Combat Predatory Lending**

During its 2008 session, the Washington State Legislature passed *An Act Relating to Homeownership Security, Responsible Mortgage Lending, and Improving Protections for Residential Mortgage Loan Consumers*. The stated purpose of the law is: “...to encourage responsible lending, protect borrowers, and preserve access to credit in the residential real estate lending market.”

The law seeks to achieve these purposes with provisions to prevent abusive and predatory lending practices.

Predatory lending is the use of abusive lending practices and the inclusion of oppressive lending terms in mortgage loan agreements. Borrowers who accept predatory loans find themselves trapped in a hopeless cycle of debt and are more likely than other borrowers to lose their homes in foreclosure actions. In communities where predatory lending is prevalent, the results are catastrophic. With multiple homeowners falling prey to predatory lending schemes or accepting loans that they cannot repay, foreclosures in some areas are so rampant that entire neighborhoods collapse.

Washington has experienced fewer foreclosures than that many other states. However, Governor Chris Gregoire formed a Task Force “...to evaluate instability in the national subprime mortgage market and ensure that the impact of this national trend is minimized in Washington.”

In a letter to the Task Force, Governor Gregoire referred to laws in other states that ban abusive lending practices and abusive terms in lending agreements and suggested “...the possibility of legislation on these topics for the upcoming legislative session.” The Washington State Legislature was responsive, and adopted new laws and amended existing laws to protect consumers in residential lending transactions, particularly those that occur in the subprime mortgage market.

Subprime loans, which are loans with interest rates above the prime rate, are typically offered to first-time borrowers who have not had an opportunity to establish credit or to borrowers with blemished credit records. Subprime loans have served as a valuable product for those who need financing for a home and who cannot qualify for a prime rate loan. Subprime lending becomes predatory lending when mortgage loan brokers and lenders offer high interest loans to borrowers who qualify for prime loans, or when they encourage borrowers to sign lending agreements with terms that are so oppressive that default on the loan and foreclosure on the home securing the debt are inevitable.

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16 House Bill 2770 Section 1
In 1994, Congress addressed the problem of predatory lending with the enactment of the Home Ownership and Equity Protection Act (HOEPA). The purposes of HOEPA are:

- To provide consumers with sufficient information to make informed choices about high-cost home loans, and
- To discourage the use of predatory lending practices associated with high cost home loans

The protections of the federal law are extended to those loans that meet an interest rate trigger or a points and fees trigger. Loans that meet these triggers are subject to special disclosure requirements, which are intended to alert consumers to the risks of accepting a high-cost home loan. HOEPA discourages the origination of predatory loans by restricting or prohibiting the use of particular lending terms and practices in loans that meet the interest rate or fee triggers.

Beginning with North Carolina in 1999, many state legislatures have passed predatory lending laws. Like HOEPA, some of these laws create special disclosure requirements and prohibited practices for loans that meet interest rate or points and fees triggers. Many of these state laws are stricter than HOEPA because they extend protections to more loans with the use of lower triggers. Washington’s new law is even stricter because it extends its protections to all “residential mortgage loans.” The Washington law does not use triggers to define the mortgage loans that are subject to special protections.

Each of the provisions of Washington’s predatory lending law is responsive to an issue raised in the final report prepared by the governor’s Task Force. Important points addressed in the report and resulting provisions in the law are discussed in the following sections. The effective date of the law was June 12, 2008.

**Loans Covered by the Law (WAC 208-660-006)**

The provisions of Washington’s predatory lending law apply to “residential mortgage loans.” Washington law defines a **residential mortgage loan** as an extension of credit that is secured by real property located in the State of Washington. The property must include a single-family dwelling or a multiple-family dwelling of four or less units, or plans for the construction of a dwelling. Excluded from the definition of residential mortgage loan are:

- Reverse mortgages
- A borrower transaction secured by rental property
- Bridge loans, which are defined as temporary loans, maturing in a year or less, that are used to acquire or construct the borrower’s principal dwelling

With no interest rate or points and fees triggers to limit the residential mortgage loans that fall within the scope of the law, application of the Washington law is very broad.
**Individuals and Entities Covered by the Law (RCW 19.144.010(6))**

The requirements of the law apply to “financial institutions,” which are broadly defined as:

- Banks and trust companies regulated by the State of Washington
- Mutual savings banks regulated by the State of Washington
- Savings and loan associations regulated by the State of Washington
- Credit unions regulated by the State of Washington
- Consumer loan companies regulated by the State of Washington
- Mortgage brokers regulated by the State of Washington

**Disclosure Requirements Created by the Law**

Most mortgage lending laws include disclosure requirements to ensure consumers receive information that will help them make knowledgeable and informed choices about loan products. One of the findings of the Task Force was that consumers are overwhelmed with the many disclosures that they receive during a mortgage transaction. The Task Force also found that consumers struggle to understand the disclosures. The Final Task Force Report questioned the effectiveness of these disclosures:

> Any consumer who has ever shopped for a mortgage or closed on a house knows how complicated the process is. The stack of paperwork that must be signed and understood during the process is very intimidating. Much of this paperwork represents disclosures which are intended to inform the borrower about the costs of the mortgage. Many times these disclosures are lengthy and difficult to read. As a result, the typical borrower may not be adequately informed about the true cost and terms of their mortgage transactions.  

In order to address this problem, the Task Force recommended the use of a one-page disclosure that includes a summary of the material terms of the mortgage lending transaction. The Task Force suggested that the borrower would receive the single page disclosure within three business days after the completion of the loan application.

In response to this recommendation, the state legislature created a new disclosure requirement for residential mortgage loans. The law requires a “disclosure summary” of all the material terms in the lending agreement on a separate sheet of paper. As suggested by the Task Force, the law states that financial institutions must provide the disclosure within three business days after receipt of a loan application.

The material terms of the lending agreement include the following: (WAC 208-600-200(4))

- Loan amount
- Interest rate

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19 Final Task Force Report, page 17
- Principal and interest payment
- Amounts of monthly reserves, including:
  - Real estate taxes
  - Homeowners/hazard insurance
  - Mortgage insurance
  - Homeowner’s association dues
- Originator/Broker/Discount Fees, including:
  - Loan origination fee
  - Broker fee
  - Loan discount fee (expressed in points and dollar amount)
  - Other fees
- Other conditions of the loan, including:
  - Existence of a prepayment penalty
  - Existence of a balloon payment
  - Whether the interest rate is locked
  - Whether the interest rate is higher due to reduced documentation
  - Whether the broker will receive a yield spread premium (as well as the dollar amount)

Any change in the material terms of the agreement will require a new disclosure summary, which is due within three business days of any material change in the lending terms or three business days prior to closing, whichever comes first. (WAC 208-600-200(6)(b)) The Department has created a model form, which is available online. 20

**Lending Terms Prohibited by the Law**

In its final report, the Task Force noted two lending terms that are particularly injurious to borrowers. These are prepayment penalties and a payment schedule that results in negative amortization. The Task Force recommended strict limitations on these lending terms.

**Prepayment Penalties (RCW 19.144.040)**

If a borrower pays off a loan balance before the loan term is over, the lender does not earn the interest that it anticipated on the loan. Prepayment penalties allow lenders to recoup losses that occur with the early repayment of a loan. However, prepayment penalties can discourage borrowers from refinancing when interest rates fall or when they qualify for a loan with a better rate. Prepayment penalty provisions are typically associated with subprime lending agreements, and they are considered an abusive lending term if they are effective after the first few years of a loan.

The Task Force noted that prepayment penalties trap borrowers in mortgages, particularly adjustable-rate mortgages, with unfavorable lending terms. The Task Force described the dilemma of many borrowers as follows:

*In recent years, many borrowers took out adjustable-rate mortgages that offered a low rate for the first few years and then 'reset' to a higher rate. In many cases those borrowers suffer when their payments increase dramatically. A prepayment penalty that extends beyond the resent period traps the borrower and makes it very difficult for them to refinance their loan.*

The Legislature responded to these findings by including a provision in the new law that prohibits the origination of a residential mortgage loan with prepayment penalties that extend beyond 60 days prior to the initial reset period of an adjustable rate mortgage. This provision in the law removes the disincentive that prepayment penalties create for refinancing a loan that has a high interest rate or other unfavorable terms.

**Negative Amortization (RCW 19.144.050)**

Negative amortization occurs when a lender establishes a repayment schedule that does not demand sufficient funds from the borrower to pay the interest due with each periodic payment. The lender adds the unpaid interest to the principal, resulting in a principal balance that increases over time. The results of negative amortization can be devastating to some borrowers. As the Task Force noted: “At the end of the loan term in this negative or non-amortizing loan, the borrower owes more than the amount originally borrowed.”

Under Washington’s predatory lending law, negative amortization is prohibited in residential mortgage loans that are subject to the Guidance on Nontraditional Mortgage Product Risks and the Statement on Subprime Lending (these guidances are discussed in a subsequent section).

**Lending Practices Prohibited by the Law**

All predatory lending practices represent a lack of good faith and the use of misleading and deceptive tactics to direct consumers towards loans that benefit unscrupulous originators at the expense of borrowers. The Washington predatory lending law prohibits “steering” and the use of schemes, misrepresentations, and other deceptive practices during mortgage lending transactions.

**Steering**

Perhaps the most common predatory lending practice is that of steering consumers towards home loans with higher interest rates than those for which they qualify. The Task Force stated: “According to a recent study by the Wall Street Journal over half of homeowners with subprime mortgages could have qualified for a prime loan with a lower interest rate.” Washington’s predatory lending law prohibits this practice.

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21 Final Task Force Report, pg 25  
22 Final Task Force Report, pg 25  
23 Final Task Force Report, pg 25
The law states that steering does not occur if the offering of a particular loan is “reasonably based” on underwriting guidelines for the borrower’s appropriate risk grade category, and the lender or other loan originator offers the borrower a choice of mortgage loan products that are within the borrower’s appropriate risk grade category.

**Fraud**

Predatory lending is a form of fraud that targets consumers. Other fraudulent schemes target lending institutions, where millions of dollars are lost to criminals who have used fictitious buyers, stolen identities, and nonexistent properties in elaborate schemes to pocket loan funds. Whether the target of mortgage fraud is an unsuspecting borrower or a lender, the practice threatens our nation’s financial soundness. The Final Task Force Report addresses this issue stating: “Combating mortgage fraud is a priority because mortgage lending and the housing market have a significant overall effect on the nation’s economy.”

There is no federal law that directly addresses the crime of mortgage fraud. Actions against those who perpetuate mortgage fraud are usually brought under statutes for conspiracy, mail fraud, bank fraud, wire fraud, and money laundering. In order to facilitate prosecutions against those who engage in fraudulent mortgage transactions, some states have passed laws that designate mortgage fraud as a specific crime. The Task Force urged the Washington legislature to join this legislative trend by creating “…a specific ‘mortgage fraud’ crime defined as a Class B felony....”

The Washington Legislature has indeed created a law that prohibits any person who is making, brokering or obtaining a residential mortgage loan from engaging in fraudulent lending activities. The law specifically prohibits:

- Using a scheme to defraud or materially mislead a borrower or a lender
- Using a scheme to obtain property by fraud or misrepresentation
- Knowingly making misstatements, misrepresentations, or omissions that a lender, borrower or other party to the lending transaction may rely on
- Using or facilitating the use of misstatements, misrepresentations, or omissions with the intention that a lender, borrower, of other party to the lending transaction will rely on it
- Receiving any proceeds (or any other thing of value) in connection with a mortgage closing, knowing that the proceeds have come from a fraudulent scheme or transaction

As suggested by the Task Force, the legislature defines these fraudulent activities as a Class B felony, and those convicted can serve up to five years in prison. The law provides that it is also a Class B felony to alter, destroy, or conceal information or to otherwise impede an investigation for mortgage fraud.

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24 Final Task Force Report, pg 26
25 Final Task Force Report, pg 26
Incorporation of the Guidances on Nontraditional Mortgage Products and Subprime Mortgage Lending

Compared to state predatory lending laws that are modeled on HOEPA, Washington’s law has a limited list of prohibited lending terms and practices. Prohibited terms and practices found in other state laws include: the financing of points and fees, financing of insurance products, acceleration of indebtedness, increased interest rate after default, the repeated refinancing of a loan, and making lending decisions based on the equity available in a borrower’s home instead of a thorough assessment of the borrower’s repayment ability.

The Washington law does not directly address these terms and practices that are often associated with predatory loans. However, the law incorporates guidances on nontraditional mortgages and subprime lending, and these guidances address many of the important issues that relate to mortgage lending in the subprime market. The guidances that the law incorporates are:

- The September 2006 Interagency Guidance on Nontraditional Mortgage Product Risks
- The November 2006 Guidance on Nontraditional Mortgage Product Risks that applies to state-regulated entities and individuals
- The 2007 Statement on Subprime Lending

The Washington legislature gives these guidances the force and effect of law by requiring the Department of Financial Institutions to “apply” them to financial institutions and by requiring financial institutions to adopt and follow internal policies that can achieve the objectives established in the guidances. The objectives and standards established by these guidances are discussed below. (RCW 19.144.030)

Guidance on Nontraditional Mortgage Product Risks

Nontraditional mortgages include such products as interest-only adjustable rate mortgages (ARMs) and payment-option ARMs. With low monthly payments during the first months or years of the loan term, these mortgages are good for borrowers who can reasonably anticipate an increase in income or sale of the property by the time that amortizing payments begin. However, the increasing rate of delinquencies and foreclosures on these loans indicates that borrowers accept them after overestimating their future income or without understanding the repayment terms. Many state and federal regulators have conducted investigations to determine why many of these loans have failed.

In 2006, the Government Accountability Office (GAO) conducted a study to assess how much consumers understand about nontraditional mortgage products. The GAO concluded that mortgages such as interest-only ARMs and payment-option ARMs are complex products that borrowers do not understand. It also determined that disclosures currently used in lending transactions do not offer an adequate explanation of the terms included in nontraditional mortgage products. Federal and state regulatory agencies are making efforts to improve disclosure requirements for nontraditional mortgages. However, with criticism of these mortgage products mounting and Congressional hearings on nontraditional mortgage products underway, banking agencies were under pressure to offer an immediate response to the crisis.
The first response was a joint effort by the Federal Banking Regulatory Agencies. These agencies drafted a *Proposed Guidance on Nontraditional Mortgage Products*, and submitted it to the public for comment. After reviewing approximately 100 comments from depository institutions, professional associations, state financial regulatory agencies, and consumer interest groups, the federal agencies issued their final version of the *Interagency Guidance on Nontraditional Mortgage Product Risks* in October, 2006.

Many of those who submitted comments on the proposed federal guidance were concerned about the creation of standards for federally-regulated banks, savings and loans and credit unions, while leaving a large percentage of mortgage professionals, including state-licensed entities such as mortgage brokers and loan originators without guidance standards. States regulators worked quickly to fill the regulatory gap. On November 16, 2006, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) published their *Guidance on Nontraditional Mortgage Product Risks for State-Licensed Entities*. On November 30, 2006, Washington’s Department of Financial Institutions adopted the *Nontraditional Mortgage Product Risks for State-Licensed Entities* (the Guidance). The Department stated that it “…has adopted the CSBS/AARMR guidance as an additional tool in determining whether a lender or mortgage broker is in compliance with prohibited practices under Washington law.” With the state’s new predatory lending law mandating compliance with the Guidance by all state-regulated financial institutions, it is important to review the standards that the Guidance establishes. A copy of the Guidance is available on the Department’s website.

The Guidance is divided into four sections and its recommended practices consist of general recommendations rather than specific standards and practices. Following is a summary of the general recommendations presented in each of the four sections of the Guidance.

**Loan Terms and Underwriting Standards**
The Guidance addresses the need for stricter underwriting standards for nontraditional mortgages, especially with regard to the analysis of the repayment ability of the borrower. The Guidance states: “...underwriting standards should address the effect of a substantial payment increase on the borrower’s capacity to repay when loan amortization begins.”

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29 *Guidance on Nontraditional Mortgage Product Risks*, page 3
While emphasizing the importance of a more thorough repayment analysis for nontraditional loans, the Guidance urges the most stringent repayment analysis for:

- Nontraditional mortgages that include reduced documentation and/or the simultaneous origination of a second-lien loan
- Nontraditional loans offered to subprime borrowers
- Nontraditional loans that finance the purchase of non-owner-occupied investment properties

With regard to underwriting, the Guidance strongly discourages certain lending practices and terms. Making a collateral-dependent loan in which the borrower has no source for repayment other than the collateral is a practice that is essentially prohibited. The Guidance warns: “Providers that originate collateral-dependent mortgage loans may be subject to criticism and corrective action.”

The Guidance also discourages lenders from making loans characterized by a large spread between low introductory rates and the fully indexed rate. With these types of loans, “…borrowers are more likely to experience negative amortization, severe payment shock and an earlier-than-scheduled recasting of monthly payments.”

**Risk Management**

The Guidance states that originators of nontraditional mortgage loans “…should adopt more robust management practices and manage these exposures in a thoughtful, systematic manner.” The need for strict management practices is especially critical for loan providers with concentrations in nontraditional mortgages. The Guidance does not establish specific requirements for risk management, but it does suggest the following as components of an effective risk management policy:

- Establish appropriate limits on risk layering (An example of risk layering is offering a nontraditional mortgage to a borrower with poor credit scores and using reduced documentation, thereby assuming three distinct types of risk in making the loan)
- Set growth and volume limits by loan type
- Monitor compliance with underwriting standards
- Oversee the practice of third parties such as mortgage brokers
- Consider how to respond if the secondary market decreases its purchase of nontraditional loans
- Anticipate the need to repurchase nontraditional loans if the sold loan losses exceed expectations

Poor performance in the subprime market beginning in the spring of 2007, increased foreclosures on nontraditional mortgages, and the termination of many businesses that made or purchased

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30 Guidance on Nontraditional Mortgage Product Risks, page 5
31 Guidance on Nontraditional Mortgage Product Risks, page 5
32 Guidance on Nontraditional Mortgage Product Risks, page 6
subprime loans showed that too many members of the subprime lending market were operating without adequate risk management practices.

**Consumer Protection**
The Guidance urges originators to provide consumers with information on the risks of nontraditional mortgages even before they receive disclosures required under the Truth-in-Lending Act. Ideally, consumers should have information about the risks associated with products like interest-only loans and payment-option loans while shopping for a mortgage.

The Guidance also urges the protection of consumers by avoiding the use of promotional materials that emphasize the benefits of nontraditional mortgages without describing their liabilities. Misleading advertisements are not only a disservice to consumers, but they place the advertiser at risk for administrative enforcement actions, lawsuits, and penalties under the Truth-in-Lending Act, the Federal Trade Commission Act, and Washington’s Consumer Protection Act.

**Recommended Practices**
Recommended practices for addressing the risks associated with nontraditional mortgages include:

- The use of good communication with loan applicants
- The development and use of effective control systems for legal compliance and risk management

**Communication with Consumers**
One of the most important aspects of good client communication is advising loan applicants of the risk associated with nontraditional ARMs. These risks include:

- Payment shock when amortizing payments begin
- Loss of equity in the home used to secure the mortgage if the payment agreement allows negative amortization to occur
- The inclusion of prepayment penalty terms in the agreement
- Additional costs associated with reduced documentation loans

**Control Systems**
Control systems for the origination of nontraditional mortgage products should include:

- Employee training to ensure that originators communicate effectively with loan applicants about the risks and benefits of nontraditional mortgages and accurate information on new mortgage products, as they evolve
- Use of compensation programs that do not encourage originators to direct loan applicant to expensive risky products
- Measures by mortgage companies to ensure that third parties, such as independent brokers, are effectively managed and are operating in compliance with the law
When incorporating the Guidance into the new predatory lending law, the Washington legislature charged the Department of Financial Institutions with the job of adopting rules to guide the regulated community into compliance with the standards that are articulated in the Guidance. Until these rules are available, Washington financial institutions that are subject to the new law should work closely with a compliance team that has a full understanding of the standards created by the Guidance.

**Statement on Subprime Mortgage Lending**

Six months after publishing the *Guidance on Nontraditional Mortgage Product Risks*, the Federal Bank Regulatory Agencies determined that it was important to provide a direct response to the crisis unfolding in the subprime lending market. They drafted a supervisory guidance that focuses on the risks of making ARM loans to subprime borrowers. The Federal Reserve published the final version of the *Statement on Subprime Mortgage Lending* on June 28, 2007.

Once again, CSBS and AARMR took part in drafting a parallel state guidance. Washington’s Department of Financial Institutions adopted the Statement on Subprime Mortgage Lending (Subprime Statement) on July 20, 2007. When adopting the Subprime Statement, the Department of Financial Institutions stated: “Mortgage originators should follow these standards when marketing and selling certain adjustable-rate mortgage (ARM) products, especially to subprime borrowers.”33 A copy of the CSBS/AARMR Subprime Statement is available on the Department’s website.

Both the federal and state guidances on subprime loans describe subprime borrowers as those who demonstrate a higher credit risk due to:

- Two or more 30-day delinquencies within the prior 12 months
- One or more 60-day delinquencies within the prior 24 months
- Foreclosure, repossession, or charge-off within the prior 24 months
- Bankruptcy within the previous five years
- Credit scores that represent a high risk of default
- Debt-to-income ratio of 50% or higher

Often, these borrowers are desperate for debt relief and are attracted to ARMs with low introductory rates. These ARMs soon adjust to much higher rates, resulting in payment shock and even default for the borrower. The guidances identify the riskiest loans as ARMs that include any of the following features:

- A low introductory rate that expires after a short period
- High interest rate caps or no rate caps
- No documentation or limited documentation of the borrower’s income

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- High prepayment penalties or prepayment penalties that are in force for an extended period of time

**Risk Layering**

The Subprime Statement refers to the Nontraditional Mortgage Product guidances that the Federal Bank Regulatory agencies and the CSBS/AARMR published in 2006, and encourage the use of these documents in defining sound underwriting principles for subprime ARMs. Both the Nontraditional Mortgage Product guidances and the Subprime Statement issue strong warnings against risk layering.

An example of common risk layering is the origination of a simultaneous second lien mortgage with no documentation of income or assets while making a first lien subprime ARM. The CSBS/AARMR Subprime Statement does not forbid risk layering, but provides that practices such as reduced documentation in the making of a risky mortgage product “*should be accepted only when there are mitigating factors that clearly minimize the need for direct verification of repayment capacity.*”

Furthermore, if there are mitigating factors, the originator must document them.

**Control Systems**

The Subprime Statement encourages the development of control systems that will ensure that loan originators follow sound lending practices. Effective control systems should:

- Establish criteria for the hiring and training of personnel
- Ensure that third party service providers, such as appraisers, are competent
- Create compensation programs that do not reward originators for steering loan applicants towards subprime ARMs instead of encouraging them to consider other products

**Communication**

The Subprime Statement strongly encourages complete communication with loan applicants. In particular, originators should help loan applicants to understand:

- The risk of payment shock when an initial rate expires
- The consequences of accepting a lending agreement that includes prepayment penalties and balloon payments
- The need to set aside cash to cover taxes and insurance when the monthly payment does not cover these expenses
- Any additional costs they may assume when accepting a reduced documentation loan

Communication with loan applicants is the key to preventing default on subprime loans. Clear and meaningful communication between loan originators and loan applicants will allow borrowers to make informed choices about the mortgage products that they choose. If borrowers understand the choices that they are making, they are more likely to make choices that meet their financial needs and goals.

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34 Statement on Subprime Mortgage Lending, Page 6.
Discussion Scenario: Consumer Complaint Letter

March 16, 2010
State of Washington
Department of Financial Institutions

To Whom It May Concern:

On February 2, 2010 I telephoned the Marvelous Mortgage Company of Anytown, Washington. I spoke to a Robert DoGood. On that day, Mr. DoGood advised me that his company was one of the most competitive in the state. He told me the rate to refinance my mortgage for 15 years would be 6.625% and zero points. He also told me that based upon the information I gave and my credit report that I would also qualify for this loan with ease – “slam dunk” I believe were his exact words.

A sudden death in my family made it impossible for me to see Mr. DoGood until February 13th. On the morning of the 13th, I called Mr. DoGood to confirm our appointment and to verify that my rate would still be 6.625% with zero points – which he indeed confirmed. That evening when Mr. DoGood arrived at my home for our appointment (late), he advised me that turmoil in the market that afternoon caused the rates to go up to 6.75%. We proceeded to complete the application anyway.

After apologizing for his lateness, Mr. DoGood quickly completed the application, told me to review the documents and disclosures he asked me to sign, and because he was unable to make copies of our originals at that time, he said he would have his processor forward my originals back to me with some additional papers.

I left a message for Mr. DoGood on February 27th. When he returned my call, I asked how everything was going and he said “fine.” I indicated that I had read that rates were going up and I was relieved because I knew I had a 30-day lock. I asked when the appraisal was going to be done and he said that it had been ordered but that the appraisers were quite busy this time of year. He said he would check on it, but not to worry, I would be closing soon.

On March 16th, Mr. DoGood advised me that my rate would be 7.375%. I told Mr. DoGood that wasn’t what I was told my rate would be and that I wanted my money back. He said that the fees he collected from me were already spent and that my rate was “floating.” He said he would forward a copy of the appraisal to me but that no money would be refunded.

I am sick about the loss of money as well as the time I have wasted, especially now that rates are almost a full point higher! Can you please help me get my money back?

Thank you,
I.M. NotHappy
Marvelous Mortgage Company Loan Log

Borrower: I.M. NotHappy  Loan No. 12341-0
Address: 4332 W Anywhere St  LO/Proc: R. DoGood/L. Smith

2/13/10 Notes to processor
Linda – copy attached original documents and return to borrower. Open file and send GFE, TIL and broker agreement. Lock loan at Investor A at 6.625% and zero points. (RD)

2/16/10
Opened file, ordered appraisal, sent originals back to borrower. (LS)

2/18/10
Credit report back – looks OK – alt. doc, should be ready to go to UW as soon as I get appraisal. (LS)

2/18/10 Notes to processor
Linda – lock-in fax confirmation to Investor A shows busy, called Stan in secondary marketing dept., he shows NO LOCK! Rates have moved…will have to float. Notice we didn’t send the GFE/TILA/Retention …back date disclosures but do not send lock confirmation or retention agreement. (RD)

2/27/10 Notes to processor
Linda – borrower called on appraisal. What is status? (RD)

2/27/10 Notes to LO
Rob – I called Fabulous Appraisal – Betty said they let their clerical person go because of mistakes, couldn’t find order. Will send Tom out ASAP. Rates are rising and loan is still not locked yet. (LS)

3/4/10
Loan submitted to Investor A (LS)

3/6/10 Notes to LO
Rob – loan approved – rate is floating; need to send approval letter. (LS)

3/6/10 Notes to processor
Send approval out dated March 9 at original rate and zero points. Will advise borrower we are unable to close… don’t see lock agreement in file (RD)

3/11/10
Advised borrower, investor needed 48 hours notice to close, plus loan has to fund within rescission period. Only thing we can do is wait until original “lock” expires, then get the best market price. Will call borrower on 3/16/10. (RD)

Discussion Questions

Refer to the Consumer Complaint Letter. How do you think this complaint might be:

- Handled by the regulator?
- Handled by Marvelous Mortgage Company?

Refer to the Marvelous Mortgage Company Loan Log. How could better communication have affected or prevented the complaint? What about follow-up?
Refer to the Consumer Complaint Letter and Loan Log. What potential perceptions have been created by the interaction between the consumer and the mortgage company?

- Perception of the regulator
- Perception of the consumer
- Perception of the mortgage company owner/management

Do you think the loan originator’s actions were ethical or unethical? What most influenced your decision?

Consumer Complaint Letter: The Potential Outcome

It is a possibility that a complaint letter such as this could motivate the regulator to investigate the mortgage broker company. While Rob DoGood’s actions might not be standard operating procedure for all loan originators at his company, I.M. NotHappy’s complaint certainly puts the company at risk for being put under the microscope.

The company would be wise to take a close look at its policies and procedures pertaining to rate locks and floating rates. Management may need to retrain staff and ensure loan originators are clear on following borrower requests to lock an interest rate.

Based on discrepancies between the consumer’s complaint letter to the regulator and the notes in the Loan Log, it appears that Rob DoGood did a poor job of communicating with I.M. NotHappy and, in fact, may have lied about certain aspects of the loan process. Appropriately advising the customer about the rate lock situation, and possibly the appraisal, seem questionable.

Ultimately the loan originator handled the rate lock in a sloppy and unethical manner. Mistakes happen, but the customer should have been advised immediately when it was discovered that the rate was not locked as expected. The telling event is I.M. NotHappy’s description of a call placed to Rob DoGood on February 27th – the loan originator was well aware the rate was floating based on the Loan Log, but the customer was under the impression the rate was locked.