Cases and Regulations: 2016 Predictions

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I have noticed that there has been a spate of articles in the last few months about the regulatory events of 2015. Indeed, the highest profile event was the implementation of the rules governing TILA-RESPA Integration Disclosure ("TRID"). Looking back at history is important; after all, "what's past is prologue,"[1] as Shakespeare's insight offers in The Tempest. Or is it? Can our vision be so blurred by the emoluments of the past that we lose sight of the recompense awaiting us in the future?

Enjoy'd no sooner but despised straight,
Past reason hunted, and no sooner had
Past reason hated, as a swallow'd bait
On purpose laid to make the taker mad;
Mad in pursuit and in possession so;
Had, having, and in quest to have, extreme.

Thus said Shakespeare in Sonnet 129, pouting how past sentiments can beguile future attractions in inscrutable ways, focused on consuming demands, whipped from one extreme to another, passionately meeting the madness of a gripping mission. Having gone through 2015's glut of objections, tests, threats, claims, confrontations, defiances, demurs, provocations, remonstrances, ultimatums, impositions, exigencies, and importunities, perhaps now we should set our zealous pursuit of adaptation and expediency to the dispatch that is likely awaiting us in 2016.

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I propose to discuss two categories that, though separate in purpose and determinate qualities, are each intrinsic to the way residential mortgage lenders and originators, as well as other financial service entities involved in extending credit through consumer loan products, will be responsive to the regulatory compliance environment in the year ahead: cases and regulations. Each often is rooted in the past, though usually springs to a trajectory into the future. Instead of traveling down Memory Lane, let's take a modest excursion through the imminent happenings soon to come. In briefly discussing these cases and regulations, I hope to further stimulate public policy debates.

CASES

Both the U.S. Supreme Court and the Second Circuit will be prominent in deciding cases affecting the origination of mortgages in 2016. Also, the D.C. Circuit and the D.C. district court will adjudicate pertinent cases. The range of consequences is considerable, from cases that could make it more difficult to consummate secondary market transactions to cases further limiting class actions. I believe the following five cases should be on a watch list.

PHH Corp. et al. v. Consumer Financial Protection Bureau[2]

I have been following this case since its inception. In its recent iteration, on November 5, 2015 the Consumer Financial Protection Bureau ("Bureau") stated in a brief filed with the D.C. Circuit that its $109 million disgorgement order against PHH Corp. in a mortgage reinsurance kickback case met all statutory requirements and should be allowed to stand in order to keep other companies from engaging in similar schemes.

The Bureau contends that PHH incorrectly interpreted the Real Estate Settlement Procedures Act ("RESPA") in its appeal of the $109 million disgorgement order. The Bureau and its Director, Richard Cordray, contend that they were correct in levying the foregoing penalty, which, they claim, serves as a necessary deterrent to other firms that might consider engaging in kickback schemes.

To quote the Bureau itself:

> "Eliminating kickbacks is a primary goal of RESPA. If PHH is permitted to keep the fruits of its kickback scheme merely because it claims it believed its scheme was legal, this will encourage others to take advantage of areas of statutory uncertainty."

Further, the Bureau contests PHH's claims that the agency's 'single-director structure,' as opposed to 'multimember-commission leadership,' and funding through the Federal Reserve rather than the congressional appropriations process, violate the U.S. Constitution.

To refresh the history of this matter, the Bureau had filed administrative claims against PHH in January 2014, alleging that when PHH originated mortgages, the financial institution referred consumers to mortgage insurers with which it had relationships. In exchange for this referral, the agency claimed, these insurers purchased reinsurance from PHH's subsidiaries, and PHH took the reinsurance fees as kickbacks.

The Bureau contended that PHH also charged more money for loans to consumers who did not buy mortgage insurance from one of its supposed kickback partners and, in general, charged consumers additional percentage points on their loans.

Then, in June 2015, Director Cordray upheld a November 2014 ruling by Administrative Law Judge Cameron Elliot that PHH engaged in a mortgage insurance kickback scheme under RESPA; but, according to Director Corday, the judge incorrectly assessed the penalties.

Director Cordray's position may be outlined, as follows:

> Rather than requiring that PHH face a penalty for kickbacks on mortgages that closed on or after July 21, 2008 – three years before the CFPB took over RESPA enforcement from the U.S. Department of Housing and Urban Development – the firm should be penalized for each payment it received after that date, regardless of when the mortgage had closed.

Mr. Cordray based his decision on the way mortgage reinsurance premiums are paid. Thus, rather than coming as a one-time payment at the closing date of a mortgage, such premiums are paid by borrowers each time they make a monthly mortgage payment.

To take a line directly from Director Cordray's opinion, "That means PHH is liable for each payment it accepted on or after July 21, 2008, even if the loan with which that payment was associated had closed prior to that date."

Thus the penalty changed as a result of a differing reading of the law, which increased PHH's penalty by over 1600% - from $6.4 million in Judge Elliot's ruling, based on the amount borrowers paid on mortgages that closed on or after July 21, 2008 to the new penalty calculation of $109 million!

To return to the present, PHH appealed the decision and the D.C. Circuit put a stay on the ruling. The firm argues that the due process clause bars the government from retroactively punishing conduct that was recognized as lawful at the time.

PHH is challenging the Bureau's internal appeals process, which turned a $6.4 million penalty for a violation of the Real Estate Settlement Procedures Act into a $109 million penalty.

The company is challenging the Director Cordray's interpretation of RESPA, which gave the impetus to the escalation of the penalty. Furthermore, it is contesting the process under which Director Cordray is the sole party to hear a review of administrative rulings.

If PHH prevails, the Bureau's strategy of setting rules on the basis of enforcement actions rather than through the normative process of public rulemaking and judicial vetting would be compromised.

Midland Funding LLC et al. v. Saliha Madden[3]

The Supreme Court is about to determine if it will hear an appeal of the Second Circuit's ruling in Manning v. Midland Funding, a decisiotgrn the state's 16 percent limit. The effect of the Second Circuit's decision has sent shock waves through the world of consumer loan products, such as credit cards, since, if upheld, it would set aside certain authorities under the National Bank Act; specifically, the right of banks to sell their products, where originated through a national bank, to purchasers of such debt without regard to state usury limits.

Spokeo Inc. v. Thomas Robins et al. and Campbell-Ewald Co. v. Gomez[4]

The litigation here involves an attempt to limit the size and scope of class action lawsuits. It is being heard by the Supreme Court. There is a coupling of cases in this matter, the Spokeo case and the Campbell-Ewald case. In Spokeo, the decision will be whether consumers will be able to bring class action claims when they cannot point to any concrete harm meted out by the defendant. The ruling could limit the number of plaintiffs that can be included in a class action. Indeed, it might even proscribe some claims under the Fair Credit Reporting Act and other statutes.

The nexus to Campbell-Ewald, a case that could allow companies to cut off class actions by merely making an offer to settle to the lead plaintiff, would likely make it much harder for large class actions to survive motions to dismiss.

FDIC v. Chase Mortgage Finance Inc.[5]

This case is in the Second Circuit from a lower court. The FDIC, acting as receiver for a failed bank, is seeking to overturn a lower court ruling that a lawsuit against Chase was time-barred. Essentially, the issue turns on whether the bank regulator can rely on federal law to defeat state statutes of repose to continue to bring cases, such as those that go back to the financial crisis. The court could move to limit the ability of regulators to continue to bring those actions if it rules in favor of Chase Mortgage Finance.

A word about the implications of defeating state statutes of repose. A statute of repose law cuts off the rights of all parties to bring a legal action. Certainty on the length of a window of vulnerability to lawsuits makes it possible to measure risk and the possible exposure to claims. In effect, a statute of repose bars

the bringing of a suit after a set period of time, regardless of whether an injury has occurred or a claim has arisen.

In this case, the FDIC argues that the Supreme Court's ruling in another case, CTS Corp. v. Waldburger,[6] which held that federal law does not preempt state statutes of repose, does not limit its ability to bring cases related to the failure of a bank during the recent financial crisis.

The effect of not being able to bring litigation after the statute of repose has passed is significant: if the Second Circuit upholds the lower court ruling, regulators will not be able to bring cases, at least in the Second Circuit. In other words, much litigation brought by regulators may have their commencement several years ago, but now, if the statute of repose has ended, and, barring an extension, such litigation would be discontinued.

Consumer Financial Services Association of America et al. v. Federal Deposit Insurance Corp.[7]

Operation Choke Point is at the root of this case, which is being tried in D.C. District Court. Operation Choke Point is an initiative of the U.S. Department of Justice ("DOJ"). Announced in 2013, the initiative investigates banks in the United States and the business they do with payment processors, payday lenders, and other companies believed to be at higher risk for fraud and money laundering.

The purpose of this initiative is to enable the DOJ to cut off illegal business activities from the banking system. The pushback is that this initiative is more about politically unpopular activities than worries about fraud and money laundering. The plaintiff is the association that represents payday lenders.

Take note that the DOJ is actually not the defendant in this case. The defendant is the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve Board ("FRB"), and the Office of the Comptroller of the Currency ("OCC"). Principally, the allegation is that the foregoing abused their supervisory powers by pressuring banks to cut off business relationships with payday lenders.

Several issues are in contention, such as whether due process is being by-passed or the government is pressuring the financial industry to cut off the plaintiff's access to banking services, without first having shown that the targeted plaintiffs are violating the law.

So far, the matter has survived a motion to dismiss from the regulators. Somewhat at stake is the increased regulatory oversight of banks since the financial crisis, in that there is a contention that the regulators have gone past the limits of their authorities.

REGULATIONS

As I see it, several areas of regulatory compliance will be developed extensively in 2016, most notably anti-money laundering ("AML"), cybersecurity, payday lending, mandatory arbitration, various technologies, and capital ratios.

The New York State Department of Financial Services ("DFS") seems to be taking the lead on cybersecurity and AML regulations. The Bureau has focused on increased oversight of payday lenders, prepaid cards, and consumer arbitration clauses. In addition, capital rules will come under more scrutiny by FRB, FDIC, and the OCC.

Cybersecurity and Anti-Money Laundering

The stage is set for significant rules to be implemented for cybersecurity and anti-money laundering processes. Leading the way is New York's DFS. In November 2015, the DFS set forth standards for cybersecurity. The DFS has said that it will lay out the provisions in a full proposal at some point in the near future. What is known at this time are standards involving multifactor authentication requiring additional sign-in credentials above and beyond passwords for key databases, mandatory annual audits, and the appointment of a single officer to oversee information security.

Our bank clients for the most part already have such protocols in place. However, non-banks will need to catch up to a more state-of-the-art cybersecurity program, irrespective of the costs. Implementing cybersecurity can be expensive and a full review should be undertaken for both cybersecurity and information security.

The DFS has also set its sight on anti-money laundering regulations. Specifically, in December 2015 it issued a proposal that is expected to be become final in 2016. A salient requirement under the rule will mandate the compliance officer to sign off on a company's anti-money laundering efforts. But, the responsibility will not end there. If certain failures occur that undercut compliance certification, the DFS would like to hold the compliance officer individually responsible; indeed, the responsibility could lead to criminal charges of lying to regulators in the event the certification is not entirely supported by evidence of implementation and testing.

Holding compliance officers responsible for defects in certification is a tall order, not least of which could lead to difficulty employing individuals who would be willing to take on such personal liability. Why stop at compliance officers? What not direct such personal liability to executive management or the Board of Directors? Where does the buck stop?

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Managing an anti-money laundering program is very demanding. Certifying comprehensive, complete and total compliance of all vectors involved in such certification is very difficult to ensure, especially with the ever changing schemes of bad actors that seek to defeat the anti-money laundering protocols of the banking system.

Consumer Financial Services Market

The Bureau will continue to follow a rigorous, and aggressive, agenda in 2016, certainly evident in its challenges to the way payday lending and debt collection are conducted, reducing the impact of mandatory arbitration clauses, and even setting rules for virtual currencies (such as Bitcoin) for prepaid cards.

In March 2015, the Bureau issued a proposal to payday lenders that caused quite a stir in that lending space. In essence, the Bureau's outline would mandate changes to many of the practices involving low income consumers, those most effected by payday lending.

The proposal would curtail so-called "debt traps" by requiring companies to determine a borrower's ability to repay small dollar, short term loans, similar to what is required now for mortgages. Additionally, the means by which lenders collect payment for those loans will change.

Having already sent the outline to a small business review panel, the Bureau expects to issue a formal proposal soon, followed by a final rule thereafter. One gets the impression that there will be huge battles forthcoming, but, inevitably, it is quite possible that 'resistance is futile.'

Mandatory arbitration will also be on the battle front, as the Bureau will be proceeding with rules that limit mandatory arbitration clauses in consumer credit contracts (i.e., credit cards).

The Bureau wants to bar financial firms from inserting class action bans into arbitration clauses, among other things. A small business review panel received the Bureau's outline in December 2015. Needless to say, mortgage industry members and associations are already getting ready for extensive, complex, and exhaustive actions and litigation to thwart the Bureau's plans.

With respect to debt collection and, to some extent, checking account overdraft fees, the Bureau will issue new rules governing those activities.

But it is in the area of prepaid credit card transactions that I expect the Bureau to issue broad, final rules that will cause considerable consternation in that market. If the Bureau proceeds as planned, the final rules would require companies, for the first time, to limit a consumer's losses when funds are stolen or

the cards are lost, investigate and fix errors, provide free access to account information, and apply certain credit card protections if credit is offered in connection with a prepaid account.

The broad casting of the final rule might bring consumer protection requirements to companies accepting Bitcoin, which would likely be comparable to similar requirements set by New York's DFS in 2015, but this time on a national scale.

Capital Rules Still to Come

An important change to come in 2016 for banks will be the proposal regarding the so-called Net Stable Funding Ratio ("NSFR"). This concept comes from a proposal of the Basel Committee for Banking Supervision, a panel of global banking regulators. It is based on the view that bank funding mechanisms were accelerators of the 2008 financial crisis and thus a potential systemic hazard.

During the financial crisis, several banks suffered a liquidity crunch, due to their over-reliance on short term, wholesale funding from the interbank lending market. As a result, the G20, an international forum for the governments and central bank governors from 20 major economies, launched an overhaul of banking regulation known as Basel III. In addition to changes in capital requirements, Basel III also contains two entirely new liquidity requirements: the net stable funding ratio (NSFR) and the liquidity coverage ratio (LCR). On October 31 2014, the Basel Committee on Banking Supervision issued its final Net Stable Funding Ratio (it was initially proposed in 2010 and re-proposed in January 2014). The NSFR directly addresses long term liquidity needs. Both ratios are landmark requirements: it is planned that they will apply to all banks worldwide if they are engaged in international banking.

Essentially, NSFR will mandate banks to hold sufficient cash or assets that can be quickly turned into cash to cover their potential losses over the course of a year. The prudential regulators are expected to promulgate actionable rules at some point in 2016.

However, the banks have complained that the Basel Committee's proposal requires a level of liquidity that far outmatches the needs banks face. I doubt that their position will change the view of regulators, since the initiative is part of global interactions with counterparts vis-à-vis such capital requirements.

CONCLUSION

As I began with Shakespeare, so I shall end with him, as follows:

When law can do no right,
Let it be lawful that law bar no wrong.[8]

This year brings new challenges, but also new opportunities. All things considered, it is best to take advantage of the latter, while being prepared for the former. We have much to be grateful for, having come through some pretty rough financial times. We ought to be vigilant, nimble, and receptive to change; but equally cautious and alert to any plans, whether from within or without, that could undermine the benefits we bring to the market.

For many firms, there has been much learned and they are the stronger for having not only persisted but also flourished. As we encounter new challenges, I would hope that we can ban together for the good of all market participants, seeking ways and means to ensure a stable and protective financial environment for the loan products and services that serve the needs of consumers.

[1] The Tempest, 2.1
[2] PHH Corp. et al. v. Consumer Financial Protection Bureau, Case 15-1177, U.S. Court of Appeals for the District of Columbia Circuit
[3] Midland Funding, LLC, et al., Petitioners v. Saliha Madden, Docketed: November 10, 2015, Case 15-610, U.S. Supreme Court
[4] Spokeo Inc. v. Thomas Robins et al., Case 13-1339, and Campbell-Ewald Co. v. Gomez, Case 14-857, U.S. Supreme Court
[5] FDIC v. Chase Mortgage Finance Inc. et al, Case 14-3648, U.S. Court of Appeals for the Second Circuit
[6] CTS Corp. v. Waldburger, Case 13-339, June 9, 2014, U.S. Supreme Court
[7] Consumer Financial Services Association of America et al. v. Federal Deposit Insurance Corp. et al., Case 1:14-cv-00953, U.S. District Court for the District of Columbia
[8] King John, 3.1

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