Regional Banks May Face Mortgage Fraud Scrutiny

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Now that most of the largest U.S. banks have settled claims arising out of their roles in the financial crisis, what are regulators and prosecutors likely to do next?

Given the public's increased distrust of financial institutions, the various federal and state government agencies and regulators are not likely to take a break now. Expect, rather, that significant resources will be redirected to investigating the country's smaller regional banks. Unlike the large banks, regional banks are not in a position to pay settlements in the billions of dollars and still survive, but they may be forced to pay smaller settlements commensurate with their roles in mortgage and securities fraud and their ability to pay.

As the focus of investigations shifts, smaller institutions should take steps now to ensure that their current practices are compliant with all applicable rules and regulations, implement programs to ensure continuing compliance and make these measures a part of the company culture.

FIRREA Strikes Back
The major tool that has been used by the government against the large banks is the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), a statute enacted after the savings and loan crisis in the late 1980s. Although the statute was initially intended to protect financial institutions from fraud

by third parties, it has recently been interpreted to apply more broadly, clearing the way for its use against banks for their own misrepresentations when selling mortgages and mortgage-backed securities to investors. FIRREA enables prosecutors to seek civil penalties for violation of certain criminal predicate offenses as long as the conduct "affects" a federally insured financial institution. By using FIRREA, prosecutors may take advantage of the civil burden of proof of "preponderance of the evidence" and are also afforded administrative subpoena power to seek broad pre-suit discovery.
When liability is found under FIRREA, the civil penalties imposed are subject to wide discretion by the courts. FIRREA's maximum penalties can be staggering – up to the amount of the pecuniary gain or loss that is derived or suffered from a violation – but courts are afforded wide discretion to impose lesser penalties. FIRREA does not set forth any factors for courts to consider when imposing a penalty, but the issue was addressed by the United States District Court for the Central District of California in *United States v. Mendez*, where the court set out eight pertinent considerations, including, among others, the defendant's bad faith, the egregiousness of the violation, the isolated or repeated nature of the violation and the defendant's financial ability to pay.

The Department of Justice (DOJ) and federal prosecutors have used FIRREA to pursue banks for misrepresentations when selling their interest in mortgages and mortgage-backed securities to investors and the government-sponsored enterprises, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation. Bank of America Corp.'s recent $16.65 billion settlement with DOJ includes a $5 billion dollar penalty to settle FIRREA claims related to misrepresentations as to the quality of loans that were securitized and sold to investors. Settlements by JPMorgan Chase & Co. and Citicorp also included substantial FIRREA penalties of $2 billion and $4 billion, respectively.

Yet another legal threat to banks has been lawsuits brought under the False Claims Act (FCA), which allows private citizens, as well as the government, to bring claims for fraud perpetuated against the United States. These lawsuits have alleged failures to follow FHA underwriting standards when banks originated FHA and Veterans Administration insured loans, violations of loan modification guidelines, and robosigning. In 2012, DOJ, 49 state attorneys general, and federal and state agencies reached a $25 billion settlement with BofA, Chase, Wells Fargo Bank, Citibank and Ally Financial, Inc., to settle FCA and other claims.

Regional Banks Next?

As these global settlement agreements are finalized, the large banks' troubles are beginning to fade in the rear view mirror, and government resources have begun to be refocused on scrutiny of regional banks. Public Securities and Exchange Commission disclosures made by several smaller and regional banks in recent months indicate federal probes into their home loan origination and servicing practices. Specifically, HUD and the DOJ have sought information from these smaller banks related to whether they met underwriting standards for loans insured by FHA.

Atlanta-based SunTrust Banks, Inc., for example, has already entered two settlements with the federal government and state attorneys general – an almost $1 billion settlement for loan-servicing violations and a separate $320 million settlement for failing to properly consider homeowners who applied for loan modifications. U.S. Bancorp, Minneapolis, reached a $200 million settlement with DOJ for failing to meet underwriting standards for loans insured by the FHA.

In this environment, regional banks would be well advised to consider the following steps to reduce the risk of non-compliance should an investigation be launched:

Review current compliance practices. Financial institutions should particularly review their practices in the government's primary target areas: residential home loan underwriting, servicing and modification. To the extent that any areas of non-compliance are identified, immediate steps should be taken to correct the deficiencies. These reviews should take place routinely and become part of the corporate culture. By proactively anticipating and addressing any issues, financial institutions can put themselves in a better position to avoid scrutiny from regulators.
Implement ongoing compliance initiatives. Retain experienced in-house counsel to assess regulatory compliance issues and outside counsel to review compliance initiatives. The idea here is to periodically monitor enforcement of compliance activities, and to ensure that initiatives keep up with the ever-changing regulatory landscape. These steps will be helpful in reducing the risk of an investigation being launched in the first place, but may also help reduce the fines available under the *Mendez* precedent if a financial institution becomes a target.

Make compliance part of the culture. Compliance initiatives should be institution-wide and should engage all employees. Ethics and compliance training should be provided routinely for all employees, including new hires. In particular, all employees making decisions and implementing procedures that could potentially run afoul of federal and state regulations should understand what the rules are and the importance of adhering to them.

Another good idea is to initiate an institution-wide awareness and branding campaign that includes an informational web portal about the institution's commitment to compliance as well as a series of events, including a kick-off event and series of workshops. Key employees should be required to attend mandatory informational meetings held by in-house and/or outside counsel. Institutions may also wish to consider making compliance a part of employees' evaluation criteria. Anonymous employee hotlines should also be established to help make it easier for employees to internally and confidentially report any issues and concerns.

Respond quickly and effectively to investigations. If a government investigation is launched, outside counsel should immediately be hired to serve as the liaison between the bank and the investigators, to conduct an internal investigation into the activities being scrutinized and to formulate a strategy for handling the investigation and potential litigation.

In an era where competition is already at historically high levels, the cost of retaining in-house and outside experts on compliance issues will absolutely hurt the bottom line in the short run. But the risk of exposure to lawsuits, regulatory investigations, settlements, and fines constitutes a far more serious threat to regional financial institutions that could jeopardize these institutions' reputation, profitability and very existence.

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