



John Keel, CPA
State Auditor

An Audit Report on

**The Department of Savings and
Mortgage Lending's Protection of
Consumers from Predatory
Mortgage Lending Practices**

March 2007

Report No. 07-023



John Keel, CPA
State Auditor

An Audit Report on

The Department of Savings and Mortgage Lending's Protection of Consumers from Predatory Mortgage Lending Practices

SAO Report No. 07-023
March 2007

Overall Conclusion

The Department of Savings and Mortgage Lending (Department) conducts an effective licensee application approval process, meeting the requirements specified in Texas Finance Code, Chapter 156, which is also known as the Mortgage Broker License Act.

The scope of the Department's mortgage broker inspection procedures and current staffing levels are not adequate to protect consumers from predatory mortgage lending practices. Specifically:

- The Department is not inspecting mortgage brokers with sufficient frequency; at its current pace, the Department will not complete initial inspections of all licensed mortgage brokers until fiscal year 2009, more than six years after it began inspections.
- The Department's inspections focus on whether mortgage brokers and loan officers comply with current state and federal laws. The Department does not take the extra step of looking for evidence of all predatory mortgage lending practices, such as a broker arranging loans without regard to the borrower's ability to repay.
- The Department is not able to take advantage of contingency appropriations available to it to hire additional mortgage broker examiners because it has reached the statutory limit on the amount of licensing fees it can charge mortgage brokers and loan officers.
- It is important to note that the Department regulates only a part of the mortgage process; it does not inspect or license most lenders.

Closer monitoring of the state's 24,027 licensed mortgage brokers and loan officers, such as adding steps to detect predatory lending practices during inspections, would allow the Department to provide more information regarding the extent of predatory mortgage lending in Texas.

To finance the cost of additional examiners, the Department would have to raise licensing fees paid by mortgage brokers and loan officers. The Department's licensing fees, however, are currently set at the maximum allowed under the Mortgage Broker License Act. Therefore, the Legislature would have to increase or

eliminate this cap on the license fees before the Department could hire additional examiners.

Applying additional appropriated resources toward inspections of mortgage brokers would allow the Department to improve its protection of consumers. For example, adding 10 examiners would allow the Department to complete initial inspections of all licensed mortgage brokers and loan officers about one year earlier than at current staffing levels.

The Legislature should consider eliminating or suspending the \$20 Mortgage Broker Recovery Fund fee currently collected from licensed mortgage brokers and loan officers. Fees and penalties deposited into the Mortgage Broker Recovery Fund surpass the amount needed to pay claims filed against the fund. As a result, the fund will exceed its statutory cap of \$3.5 million by the end of calendar year 2007. Once the fund reaches \$3.5 million, the fees collected will transfer into the State's General Revenue Fund.

Key Points

The Department's inspections do not include tests for several common predatory lending practices.

The Department's ability to protect consumers from predatory mortgage lending activities is limited because it does not include tests for several common predatory lending practices in its inspections of licensed mortgage brokers and loan officers. The Department inspects license holders to determine if they are following state and federal laws regulating the industry. Auditors reviewed the performance of Department examiners and found that they substantially comply with the Department's policies and procedures for inspections. Although the Department does not have authority to take enforcement actions against all predatory mortgage lending practices, it could use this information to determine the extent of predatory lending practiced by mortgage brokers in Texas.

The Department will not complete initial inspections of all licensed mortgage brokers in Texas until fiscal year 2009.

The Department has not yet inspected more than 4,100 licensed mortgage brokers. At current staffing levels, the Department will not be able to complete initial inspections of all licensed mortgage brokers in Texas until fiscal year 2009, more than six years after the Legislature authorized the Department to begin these inspections. Without regular and timely inspections, the Department cannot ensure that mortgage brokers are complying with the Mortgage Broker License Act.

The Mortgage Broker Recovery Fund fee is no longer needed to protect Texas consumers.

Fees and penalties deposited into the Mortgage Broker Recovery Fund since its creation in 1999 surpass the amount needed to pay the claims filed against the fund. The fund will reach its statutory cap of \$3.5 million in 2007. Deposits in excess of the \$3.5 million balance will be swept into the State's General Revenue Fund. Interest earned on the fund balance exceeds the amount of payouts to consumers damaged by the conduct of mortgage brokers. Under current statutory restrictions on the amount a consumer can recover from the fund, there is no need to continue collecting and depositing fees from mortgage brokers and loan officers into the fund.

Summary of Management's Response

The Department generally agrees with the recommendations made in this report.

Summary of Information Technology Review

The Department's information systems are sufficient to support its licensing and enforcement functions. However, the Department's automated information system does not always contain timely or complete information regarding inspections and enforcement activities, which may lead to improper decisions regarding license renewals. In addition, the Department makes limited use of audit trails, and its reliance on a single contractor for information system operations increases the risk that the contractor could alter data or access confidential information without detection by the Department.

Summary of Objective, Scope, and Methodology

The objective of this audit was to determine whether the Department is protecting consumers from predatory mortgage lending practices by reviewing the Department's licensee application approval procedures and enforcement procedures.

The scope of this audit included Department transactions, including financial transactions, licensing and registration decisions, mortgage broker and loan officer inspections, and investigations and enforcement actions from fiscal year 2003 through December 31, 2006.

The audit methodology included analysis of data from the Department's automated information systems, tests of selected transactions, interviews, and reviews of Department policies and procedures. It also included a review of the Mortgage Broker License Act and the related rules adopted by the Department.

Contents

Detailed Results

Chapter 1	
Increasing the Frequency of Mortgage Broker Inspections and Expanding Procedures for Detecting Predatory Mortgage Lending Practices Would Improve the Department’s Ability to Protect Consumers	1
Chapter 2	
The Recovery Fund Fee Is No Longer Needed to Protect Texas Consumers	12
Chapter 3	
The Department Conducts an Effective Licensing Process.....	14
Chapter 4	
Weaknesses in the Department’s Information System Operations Increase Risks to the Department’s Data.....	16

Appendices

Appendix 1	
Objective, Scope, and Methodology.....	18
Appendix 2	
Definition of Predatory Mortgage Lending Practices.....	21
Appendix 3	
The Role of Mortgage Brokers and Regulatory State Agencies in the Mortgage Lending Process	22
Appendix 4	
Mortgage Broker Regulations in Texas and Other States.....	24

Detailed Results

Chapter 1

Increasing the Frequency of Mortgage Broker Inspections and Expanding Procedures for Detecting Predatory Mortgage Lending Practices Would Improve the Department's Ability to Protect Consumers

The Department of Savings and Mortgage Lending's (Department) ability to protect consumers from predatory mortgage lending activities is limited because it does not include tests for several common predatory lending

Who Regulates the Mortgage Industry in Texas?

Department of Savings and Mortgage Lending:

- Licenses mortgage brokers and loan officers making or arranging first-lien mortgage loans.
- Registers mortgage bankers making first-lien mortgage loans.

State law exempts from licensing mortgage bankers and loan officers who are employed by certain organizations. Those organizations include banks, savings banks, savings and loan associations, state or federal credit unions, insurance companies, mortgage banks, 501(c)(3) organizations, and Farm Credit System institutions.

Office of Consumer Credit Commissioner:

- Licenses mortgage brokers who arrange second-lien mortgages with effective rates greater than 10 percent.
- Licenses mortgage lenders who make home equity loans (unless made with unsupervised U.S. Department of Housing and Urban Development-approved lenders) or engage in second-lien mortgages.
- Licenses second-lien mortgage lenders.

practices. As noted below, many predatory lending practices are not illegal. It is also important to note that the Department regulates only a part of the mortgage process; it does not inspect or license most lenders.

Inspecting mortgage brokers more frequently and including more steps for detecting predatory lending practices would allow the Department to provide more information regarding the extent of predatory mortgage lending in Texas. Closer monitoring of the subsequent performance of mortgage brokers found by examiners to have significant violations of state regulations, and applying additional resources toward the inspection of mortgage brokers also would increase the Department's effectiveness at protecting consumers from predatory lending.

Chapter 1-A

The Department's Inspections Do Not Include Tests for Several Common Predatory Lending Practices

The Department's examiners inspect licensed mortgage brokers and loan officers to determine if they are following state and federal laws regulating the industry. The examiners substantially comply with the Department's policies and procedures for inspections. In addition, the examiners are consistent in their grading of licensees and in their application of fines and penalties, both among examiners and across regions.

However, the Department's inspections do not include tests for several common predatory lending practices that could place homeowners at risk of losing their homes. State law does place certain restrictions on the use of these

practices; however, those restrictions apply to home-equity loans and certain high-cost second-lien mortgages, which the Department does not regulate. These practices include:

- **Lending without regard to the borrower's ability to repay.** Often, this includes the use of non-traditional mortgage products such as payment-option adjustable rate mortgages, interest-only mortgages, and negative amortization mortgages.
- **Loan flipping.** This is the refinancing of a loan to generate fee income without providing any net tangible benefit to the borrower.
- **Selling and financing unnecessary products.** This includes financing a lump-sum credit life insurance premium as part of a mortgage loan.

Non-Traditional Mortgage Products

Three examples of non-traditional mortgage products are:

- **Payment-Option Adjustable Rate Mortgages.** These are adjustable-rate mortgages that allow the borrower each month to choose among several payment options, such as a traditional payment of principal and interest; an interest-only payment; or a minimum (or limited) payment, which may be less than the amount of interest due that month.
- **Interest-Only Mortgages.** These are mortgages, usually adjustable-rate, that allow the borrower to pay only interest for a specified number of years. The interest-only payment period is typically between 3 and 10 years. After that, monthly payments increase—even if interest rates stay the same—because the borrower must pay back principal as well as interest.
- **Negative Amortization Mortgages.** These mortgages feature monthly payments that do not cover all the interest owed. The unpaid interest is added to the loan balance. This results in borrowers owing more than they did at the beginning of the loan, even after making many payments.

Source: Board of Governors of the Federal Reserve System.

Adding procedures to the Department's inspections of mortgage brokers would allow examiners to detect the use of these potentially predatory practices and provide the Department with valuable information. Although the Department does not have authority to take enforcement actions against all predatory mortgage lending practices, it could use this information to determine the extent of predatory lending practiced by mortgage brokers in Texas. This information also could prove valuable to state lawmakers. The Department could use this information to identify and conduct more frequent inspections of mortgage brokers who present a high-risk to consumers. Gathering such information could deter mortgage brokers from engaging in such practices.

The Department does not have policies and procedures in place to ensure that its examiners routinely verify all information included in annual reports that mortgage brokers file with the Department. However, the Department has identified errors and requested corrections for some gross misstatements in the annual reports. In addition, the Department does not collect information from brokers on the types and amounts of loans most commonly associated with predatory mortgage lending practices (see text box for examples of these types of loans).

The annual reports, which are required by the Mortgage Broker License Act, summarize the number and amount of loan originations performed by mortgage brokers. They also include information on each loan officer sponsored by the mortgage broker. The Department uses this information when determining which mortgage brokers to inspect and when preparing for inspections. The Department also summarizes the information in public reports that it shares with the Finance Commission and other agencies.

Without verifying the accuracy of the information submitted by the mortgage brokers, there is an increased risk that the Department may make decisions and share information with other agencies that is materially incorrect.

Recommendations

The Department should:

- Add steps designed to detect predatory mortgage lending practices to its procedures for mortgage broker inspections. In particular, examiners should determine whether mortgage brokers are:
 - ♦ Arranging loans without regard to the borrower's ability to repay.
 - ♦ Refinancing loans to generate fee income without providing any net tangible benefit to the borrowers.
 - ♦ Selling and financing unnecessary products, such as lump-sum credit life insurance premiums, as part of a mortgage loan.
- Expand the requirements for annual reports from mortgage brokers to include information on the types and amount of loans most commonly associated with predatory mortgage lending practices.
- Use the data on predatory mortgage lending practices that it obtains from inspections and annual reports to:
 - ♦ Identify and conduct closer monitoring of mortgage brokers who may represent a high risk to consumers.
 - ♦ Issue reports to State lawmakers on the extent of predatory lending practices by mortgage brokers in Texas.
- Revise its policies and procedures to ensure its examiners verify annual report information submitted by mortgage brokers when conducting inspections.

Management's Response

The Department is in general agreement with the above recommendations and commits to expand the scope of Annual Reports and take steps to enhance procedures already in place. This will be implemented within the restrictions noted in the audit: the Department's limited resources and jurisdiction.

The Audit Report correctly states that the "inspections do not include tests for several common predatory lending practices, including... Lending without

regard to the borrower's ability to repay...Loan Flipping...Selling and financing unnecessary products." These are rarely discernable when relying only on the loan documents. The pricing policies, underwriting guidelines, inclusive of the borrowers' ability to repay, are dictated by the lender/investor and not by the broker. That is why we have always dealt with these predatory issues through our complaint investigations and will continue to do so.

Inspections do focus heavily on the two other predatory lending tactics defined in the SAO Audit appendix that can most readily be determined from the loan file – Excessive Fees and Bait and Switch. The inspection process takes an aggressive approach to not only identifying these occurrences, but also penalizing the broker and providing remedies to the borrower.

Inspection procedures call for the examiner to obtain the most recent Annual Report information before entering the broker shop to determine the volume and type of lending activity. This information is then compared to the broker's application transaction log to determine the accuracy of what has been reported to the Department. Discrepancies between these two reports are almost always the direct cause of receiving one of our two harshest examination ratings and the imposition of penalties for failure to produce records. Because only a fraction of brokers are inspected in any given annual report cycle, the Department will continue its reconciliation of annual report data and the use of targeted examinations for analyzing data anomalies.

ACTION: *to best meet the full intent of this recommendation:*

- *The Director of Licensing will include a category for non-traditional mortgages in the collection of 2007 Annual Report activity. When implemented, the additional information can be used to enhance inspections. This will accomplish closer monitoring of mortgage brokers whose offered products may represent a high risk to consumers. This will also allow for reporting to State lawmakers much more meaningful information regarding predatory practices within the context of all lending.*
- *Our present practice is to impose administrative penalties when Excessive Fees, and Bait and Switch are identified. The Deputy Commissioner /Director of Examination will expand this existing policies to include information gathering for the three additional predatory activities listed, understanding that only more experienced examiners will be capable of this analysis. This policy modification will incorporate selling and financing of unnecessary products, a very restricted review of Lending without regard to the borrower's ability to repay, and Loan flipping. Selected exams addressing these three additional predatory activities will be identified through Annual Report information. This expansion in examiner duties will be covered during the examiner training scheduled*

the week of July 16, 2007 and procedures implemented following the annual report filing.

- *The General Counsel has addressed and will continue to address consumer complaints regarding loan flipping or high-pressure marketing.*

Chapter 1-B

The Department Will Not Complete Initial Inspections of All Licensed Mortgage Brokers in Texas until Fiscal Year 2009

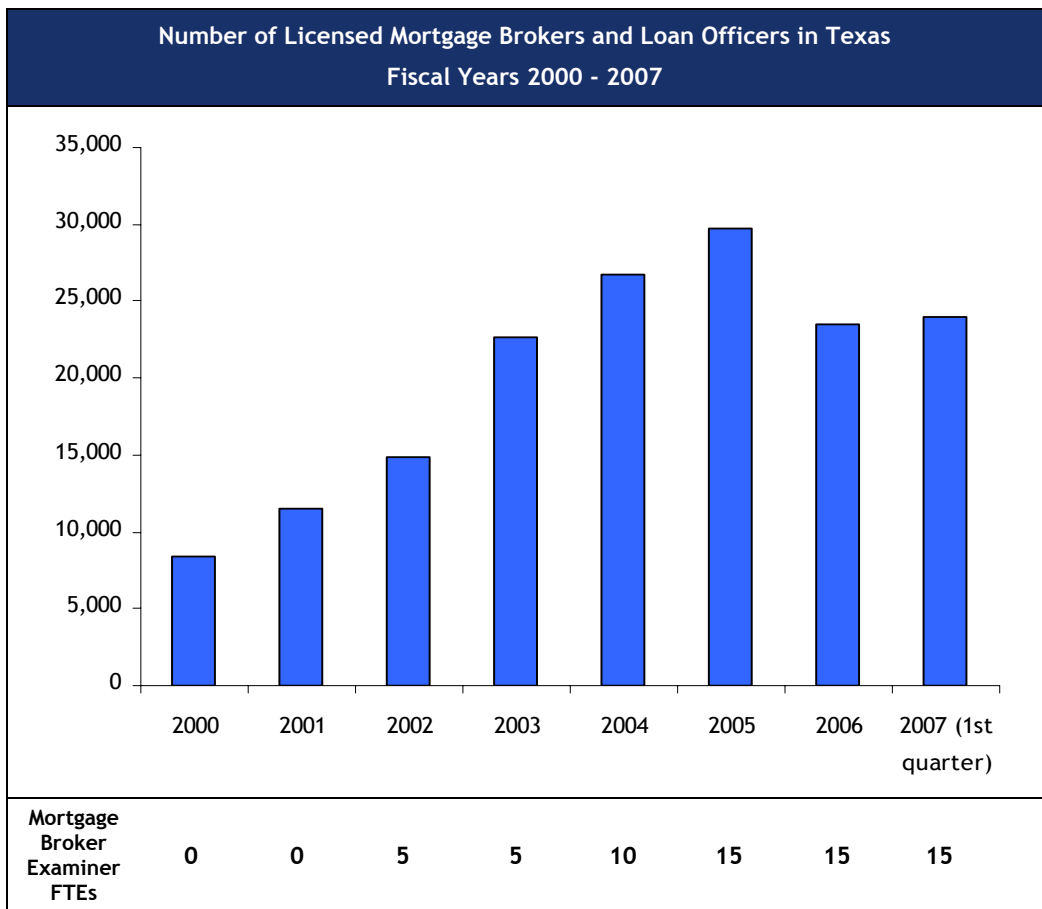
The Department has not yet inspected more than 4,100 licensed mortgage brokers. However, about one-third of those mortgage brokers have reported that they originated a limited number of loans. At current staffing levels, the Department will not be able to complete initial inspections of all licensed mortgage brokers in Texas until fiscal year 2009, more than six years after the Legislature authorized the Department to begin these inspections. Without regular and timely inspections, the Department cannot ensure that mortgage brokers are complying with the Mortgage Broker License Act.

The Department's Mortgage Broker Inspections Include Sponsored Loan Officers

Texas law requires licensed loan officers to work under the sponsorship of a licensed mortgage broker. When the Department's examiners inspect a mortgage broker's operations, they also inspect the loan officers working for the mortgage broker. As a result, some mortgage broker inspections may involve the inspection of dozens of loan officers.

The number of licensed mortgage brokers and loan officers the Department regulates has grown significantly since it began inspections in September 2002, as Figure 1 on the next page shows. At that time, the Department reports that there were 14,857 licensees (including both mortgage brokers and loan officers). As of November 2006, that number has increased to 24,027 licensees. Although the number of licensees appears to have begun stabilizing over the past year, the Department has not been able to complete its initial inspections.

Figure 1



Source: Department of Savings and Mortgage Lending.

Additional examiners would allow the Department to complete the initial inspections more quickly.

The Department employs 15 examiners, each of whom has a quota of completing 120 mortgage broker inspections per year. At that rate, the Department will need about 2.5 more years to complete initial inspections of all currently licensed mortgage brokers and loan officers in Texas. The Department intends to inspect all licensed mortgage brokers before it begins reinspecting brokers. This means it is unlikely that mortgage brokers who score poorly on inspections will be inspected again by the Department for several years. However, the Department does require poor-scoring mortgage brokers to undergo reinspection by third-party examiners at the broker's own expense until the Department is satisfied that the broker's performance has improved.

Employing more examiners would allow the Department to complete initial inspections more quickly and place mortgage brokers on a more timely cycle for return inspections. For instance, hiring 10 more examiners would allow the Department to complete the first round of inspections 12 months sooner than at current staffing levels, while hiring 25 more examiners would allow all inspections to be completed 19 months sooner. Table 1 shows the impact on the frequency of inspections after hiring and training additional examiners based on current inspection procedures. These estimates do not include other costs such as travel and administrative support costs.

Table 1

Impact of Hiring More Examiners on Frequency of Inspections				
Increase in Number of Examiners	Reduction in Time to Complete Initial Inspections of Mortgage Broker Inspections	Cycle Time Between Mortgage Broker Inspections	Estimated Annual Cost of Additional Examiners ^a	Additional Licensing Fees Needed to Cover Cost ^b
0	0 months	4.6 years	\$ 0	\$ 0.00
5	7 months	3.4 years	\$ 218,093	\$17.66
10	12 months	2.8 years	\$ 436,186	\$35.33
15	15 months	2.3 years	\$ 654,279	\$52.99
20	17 months	2.0 years	\$ 872,372	\$70.66
25	19 months	1.7 years	\$1,090,465	\$88.32

^a See Appendix 1 for a description of the methodology used to calculate costs of additional examiners and the impact on fees.

^b Fees would be assessed on all new licenses and renewals every two years.

Additional examiners would allow the Department to inspect mortgage brokers more frequently.

The Department also could improve its protection of consumers by increasing the frequency of mortgage broker inspections. For instance, hiring additional examiners would allow the Department to reduce the time needed to complete subsequent inspection cycles. At current staffing levels, it will take the Department about 4.6 years to complete the next round of inspections.

Hiring 10 additional examiners would reduce this cycle time between inspections to 2.8 years; 25 more examiners would reduce this cycle time to 1.7 years. In addition, hiring additional examiners would allow the Department to adjust the cycle time to allow closer monitoring of mortgage brokers who were found by examiners to have significant violations on previous inspections.

The Department's current 4.6-year inspection cycle time for mortgage brokers does not compare favorably to other states. For instance, Illinois inspects

mortgage brokers at least every 12 to 36 months, depending on how well the brokers did during their last inspection. Illinois places the poorest performing brokers on continuous monitoring.

Applying additional appropriated resources toward the inspection of mortgage brokers would allow the Department to better protect consumers.

The Department has not been able to take full advantage of contingency funds appropriated to the Department to increase the number of employees to maintain adequate regulation of the industry.¹ The Department must finance the cost of any additional employees by raising licensing fees paid by mortgage brokers and loan officers (see Table 1 on page 7). The increased licensing fees could help the Department implement an inspection function that better protects consumers through more timely inspections.

However, the Department has already set the licensing fees at the maximum allowed by the Mortgage Broker License Act, which caps mortgage broker application and renewal fees at \$375 for a two-year license. The cap for loan officer application and renewal fees is \$175 for a two-year license. The Legislature would need to revise the caps in the Mortgage Broker License Act before the Department could increase licensing fees to pay for additional examiner positions.

Activating its contingency appropriations to increase mortgage broker inspections would enable the Department to improve its regulation of the mortgage broker industry by adding examiners and completing initial inspections more quickly. Since fiscal year 2004, the Legislature has set aside contingency appropriations for the Department to use when the number of licensees has grown to a point where additional appropriations are deemed necessary to maintain adequate regulation of the industry. The contingency appropriation, if activated, would have allowed the Department to hire up to 30 additional employees during the 2006-2007 biennium. The Legislative Budget Board has proposed a similar contingency appropriation for the Department in the 2008-2009 biennium.

As noted in Figure 1 on Page 6, the number of licensed mortgage brokers and loan officers has grown significantly since September 2002. In response, the Department sought and obtained approval to activate the contingency appropriation in fiscal year 2005 to hire 15 additional employees. However, activation of the contingency appropriation is effective only for the current biennium. When the Department received approval to activate the appropriation and hire additional employees, it had to request and receive approval in the next legislative session to retain the additional employees in the next biennium. In this case, the Department chose to fill only 7 of the

¹ See Rider 5, page VIII-78, the General Appropriations Act, (79th Legislature).

positions after it learned its appropriations for the 2006-2007 biennium would carry forward only 7 of the 15 additional positions.

To activate the contingency appropriations, the Department must obtain a finding of fact from the Finance Commission that states either:

- The size of the mortgage broker industry under the Department's jurisdiction, determined as a function of the number of licensees, has grown to a point where additional appropriations are deemed necessary to maintain adequate regulation of the industry; or
- Increased incidents of regulatory and supervisory concern regarding compliance with applicable statutes and regulations by mortgage broker licensees under the Department's jurisdiction have occurred to the extent that additional appropriations are deemed necessary to maintain adequate regulation of the industry.

In addition, the Governor and the Legislative Budget Board must not disapprove of the Finance Commission's finding, and the Comptroller of Public Accounts must find that the Department has the increased revenues available to pay for the contingency appropriation.

Recommendations

The Legislature should consider enacting legislation to increase or remove the caps on mortgage broker and loan officer license application fees.

In addition, the Department should take the appropriate steps to:

- Raise licensing fees paid by mortgage brokers and loan officers to provide the revenue needed to fund the contingency appropriation.
- Activate the contingency appropriations at the start of fiscal year 2008 for hiring additional examiners to complete initial inspections of mortgage broker inspections more quickly.

Management's Response

In general, the Department agrees with the recommendation, but additional information is needed to present a complete picture.

If the legislature removes or raises the caps on licensing fees, the Commissioner and Chief Administrative Officer will begin the contingency rider implementation process in September 2007 and take steps to raise licensing fees, thereby providing revenue to fund contingency appropriations. We agree that a reduced inspection cycle is beneficial to the consumers of

Texas, but disagree with SAO's calculation of the fiscal impact since it includes only salary and benefits, and only at the Examiner I level. Our estimates are more than 40 percent higher than SAO's when additional costs, such as travel, telephone, and administrative support are included. Additional legal resources will also be necessary to insure that timely enforcement action can be initiated for violations discovered by these additional examiners in the inspections. Further, hiring competent, qualified staff through the contingency process creates a significant hurdle when applicants are told the positions are temporary. Consideration might be given to rolling the additional FTEs into the Department's base. The Department is a self-funding self-leveling agency and has a long history of conservatively managing FTEs.

Chapter 1-C

The Department Does Not Accurately Account for or Pursue Uncollected Administrative Penalties

The Department has been unable to provide reliable information regarding the amounts of administrative penalties it has assessed and how much remains uncollected. The Department began assessing and collecting penalties in fiscal year 2001. Since that time, it has deposited \$877,000 in penalties into the Recovery Fund. However, data from the primary automated information system used to track the Department's enforcement actions is not reconciled to the deposits in the Mortgage Broker Recovery Fund (see Chapter 2 for more information on the fund). The Department's annual debt report to the Office of the Attorney General for fiscal year 2006 listed \$74,000 in collectible debt and \$187,000 in uncollectible debt.

The Department has chosen not to pursue collection of unpaid administrative penalties from persons whose licenses have been revoked, suspended, surrendered, or expired. The Department states that removing mortgage brokers who violate laws from the industry is its primary goal—not penalty collection. Once a mortgage broker loses his or her license, the Department has achieved its goal and does not continue collection efforts. In addition, the Department believes that unpaid amounts are not collectible. However, because it does not pursue unpaid penalties and does not have reliable assessment and non-collections data, it does not know whether efforts to collect late payments would prove beneficial.

Recommendations

The Department should:

- Adopt policies and procedures that ensure it maintains accurate information on the administrative penalties it has assessed, collected, and that remain unpaid. This should include reconciling amounts between the

Department's accounting records and the automated information system used for tracking enforcement actions.

- Establish procedures for collecting delinquent penalties and a reasonable period for collection. State law requires that the rules conform to guidelines established by the Office of the Attorney General.
- Refer unpaid penalties to the Office of the Attorney General for collection.

Management's Response

The Department agrees with the above recommendations.

The Department maintains information regarding amounts of administrative penalties assessed, and can determine what has been collected and what remains uncollected. Our information system has recently been revised to capture this information in a more central location.

The Department considers its highest enforcement priority as protecting Texas consumers in their interaction with mortgage brokers. Any additional attempts to collect delinquent administrative penalties from former licensees would require diversion of resources currently dedicated to investigate, examine, and discipline active licensees for fraud, predatory practices, and improper dealing. This active population poses a greater risk of harm to Texas consumers.

ACTION: *The Director of Licensing has been assigned the responsibility for reviewing, and correcting as necessary, existing policies and procedures relating to the recording, collecting, and reconciliation of administrative penalties. Efforts are currently in process to reconcile FY 2007 deposits with the assessments and collections recorded in the automated information system. Previous fiscal year information will be addressed as necessary and completed by the end of FY 2007. In addition, the Director of Licensing, along with the General Counsel, will establish procedures for collecting delinquent penalties following the guidelines established by the Office of the Attorney General, including referring unpaid penalties to them for collection.*

The Recovery Fund Fee Is No Longer Needed to Protect Texas Consumers

Fees and penalties deposited into the Mortgage Broker Recovery Fund (Recovery Fund) since its creation in 1999 surpass the amount needed to pay the claims that have been filed against the fund. The Recovery Fund is projected to reach its statutory cap of \$3.5 million in 2007. Deposits in excess of the \$3.5 million balance will be swept into the State's General Revenue

Mortgage Broker Recovery Fund

The Mortgage Broker License Act, passed by the 76th Legislature, directed the Department to establish the Mortgage Broker Recovery Fund on September 1, 1999. This fund assists consumers who obtain a civil (monetary) judgment against a mortgage broker or loan officer who cannot pay the judgment. To receive payment, the consumer must obtain a court order directing the Department to pay the unpaid judgment amount from the Mortgage Broker Recovery Fund.

Fund. Interest alone earned on the Recovery Fund balance exceeds the amount of payouts to consumers damaged by the conduct of mortgage brokers. Under current statutory restrictions on the amount a consumer can recover from the Recovery Fund, there is no need to continue collecting and depositing fees from mortgage brokers and loan officers into the Recovery Fund.

The Mortgage Broker License Act directs the Department to finance the Recovery Fund with a fee of \$20 paid by mortgage brokers and loan officers applying for or renewing a license. In addition, the Department deposits all administrative penalties it collects into the Recovery Fund.

The Mortgage Broker License Act limits payments made out of the Recovery Fund to \$25,000 per transaction. It also limits the total amount of payments from claims against a single mortgage broker to \$50,000. However, the judgments that mortgage brokers have been unable to pay often exceed these statutory caps. For instance, six consumers have received assistance from the Recovery Fund since its inception through the end of fiscal year 2006. The amount of assistance the Recovery Fund could provide to four of those consumers was significantly less than the actual unpaid judgments. The six claims paid out from the Recovery Fund total \$146,224; the actual unpaid judgments owed to those consumers by mortgage brokers total \$960,456.

Through August 31, 2006, the Department has deposited fees totaling \$1.88 million and administrative penalties totaling \$0.88 million into the Recovery Fund. With interest revenues of \$209,229, the total deposited into the Recovery Fund since its inception is \$2.97 million. The six claims paid out from the Recovery Fund reduced its balance to \$2.82 million.

The Mortgage Broker License Act caps the Recovery Fund's balance at the end of a calendar year to \$3.5 million, with any excess balance transferring to the State's General Revenue Fund. The Department expects the Recovery Fund's balance to exceed that limit by the end of 2007. As a result, future

collections of the Recovery Fund fees and penalties will be swept into the State's General Revenue Fund.

Eliminating or suspending the statutory requirement to collect the \$20 Recovery Fund fee from mortgage brokers and loan officers would not harm the Recovery Fund. In fiscal year 2006, the Recovery Fund earned \$108,797 in interest, more than enough to cover the four claims totaling \$100,000 paid from the fund that year. Should the Recovery Fund's balance decline to \$500,000 or less after the fee is eliminated or suspended, Chapter 156 of the Texas Finance Code provides for the implementation of an additional fee of up to \$10 to replenish the fund.

Recommendations

The Legislature should consider enacting legislation to either:

- Eliminate the Recovery Fund fee, or
- Convey to the Finance Commission authority to establish the amount of the Recovery Fund fee.

Management's Response

The Department would be supportive of whatever action the legislature chooses. Conveying the authority to set the fee amount with the Finance Commission would provide greater flexibility if any future change were to become necessary.

The Department Conducts an Effective Licensing Process

The Department's process for issuing new or renewing existing mortgage broker and loan officer licenses ensures that applicants meet all significant requirements before a license is issued. The Department consistently follows its licensing policies and procedures, and the process complies with licensing provisions of the Mortgage Broker License Act. Based on its screening process, the Department reports that it denied 112 (2.1 percent) of 5,278 applications in fiscal year 2006. Auditors tested the Department's licensing approval process and found only minor errors (most were of a clerical nature).

However, the Department can improve the automated information system it relies upon for making decisions on renewing licenses. The system does not always contain timely or complete information regarding inspections and enforcement actions, which may lead to improper decisions regarding license renewals.

The Department requires applicants to pass a criminal history check, meet certain educational and experience requirements, pass a state-mandated exam, and provide proof that they meet certain financial qualifications. Enforcing these requirements helps to ensure that only qualified individuals become licensed mortgage brokers and loan officers. However, there is little more the Department can do to identify which applicants intend to use their new credentials to practice predatory mortgage lending.

Recommendations

The Department should:

- Take steps to ensure its automated information system contains all current inspection and enforcement data so it considers all relevant factors during the licensing process. If the Department continues to rely on subsidiary information systems, it should develop a process for periodically reconciling them to its primary system.
- Implement the recommendations on improving controls over the primary information system listed in Chapter 4.

Management's Response

The Department agrees with the above recommendations.

ACTION: *The General Counsel, responsible for enforcement data, and the Director of Examination, responsible for inspection data, will work with the*

Director of Licensing, the Department's database manager, to ensure that the Department's automated information system contains all the required fields for the collection and reporting of enforcement and inspection data entry no later than February 28, 2008. In addition, the Director of Licensing will assist the other managers in the development of reports to review entered data.

Weaknesses in the Department's Information System Operations Increase Risks to the Department's Data

Overall, the Department's information systems are sufficient to support its licensing and enforcement functions. The data used for management decisions or performance reporting appear valid and reliable. Key information system controls for areas such as logical access and disaster recovery are functioning properly. However, the Department makes limited use of audit trails, and its reliance on a single contractor for information system operations increases the risk that the contractor could alter data or access confidential information without detection by the Department. For instance:

- The Department does not have a formal agreement with its contract programmer to ensure the ability to upgrade the licensing application should the contractor discontinue support of the system.
- Users can install new updates before final acceptance testing and approval of the updates.
- The contract programmer has unmonitored, full-time access to production data.
- The Department does not remove confidential information from licensing data it provides to the contract programmer.

Recommendations

The Department should:

- Negotiate a contingency agreement with its contract programmer that would allow the Department to obtain the source code of the application should the contractor cease to exist or fail to provide ongoing maintenance. This agreement could take a variety of forms, such as a software escrow or some other type of agreement.
- Change the dissemination process for system updates so that updates are not available to users until after final acceptance testing and approval.
- Ensure that the contract programmer can access the Department's data as needed. In addition, the Department's network administrator should monitor the contractor's access.
- Remove confidential data fields prior to providing licensing data to the contractor.

- Identify all mission-critical information in the licensing application and implement audit trails that would document the history of changes to that information.

Management's Response

The Department agrees with the above recommendations.

ACTION: *The third recommendation, ensuring that the contract programmer can access the Department's data as needed and the monitoring of that access, was corrected during the course of the audit. The Director of Licensing will implement the remaining four recommendations no later than November 30, 2007.*

Appendices

Appendix 1

Objective, Scope, and Methodology

Objective

The audit objective was to determine whether the Department of Savings and Mortgage Lending (Department) is protecting consumers from predatory mortgage lending practices by reviewing the Department's licensee application approval procedures and enforcement procedures.

Scope

The scope of this audit included Department transactions, including financial transactions, licensing and registration decisions, mortgage broker and loan officer inspections, and investigations and enforcement actions from fiscal year 2003 through December 31, 2006.

Methodology

The audit methodology included literature review, analysis of data from Department information systems, tests of selected transactions, and interviews.

Information collected and reviewed included the following:

- A review of recent literature on predatory lending, including news clippings and online articles.
- The results of interim studies from the Texas Senate and Texas House of Representatives.
- Compilation of laws and practices from other states.
- Texas Finance Code, Chapter 156 (also known as the Mortgage Brokers License Act).
- Title 7, Texas Administrative Code, Chapter 80.
- General Appropriations Acts riders from 2000 through 2006.
- Department policies and procedures.
- Other Department publications and reports, including its annual financial report and operating budget.

Procedures and tests conducted included the following:

- Analysis of Department enforcement orders.
- Analysis of data from the Department's primary information system. This included an assessment of the system's reliability.
- Walk-throughs of various procedures and development of detailed flowcharts for the Department's licensing, examination, investigation, and enforcement functions.
- Analysis of payroll and staffing records as they pertain to cycle times for inspections.
- Testing of selected licensing and renewal decisions.
- Testing of inspection and investigation files for consistency and compliance with Department procedures.
- Observation of a Finance Commission meeting, an interagency work group meeting, and an administrative hearing.
- Interviews with the chair of the Finance Commission's audit committee and with executive management and staff.
- Analysis of data from the Uniform Statewide Accounting System.
- Estimation of the cost of hiring additional mortgage broker examiners. Auditors calculated the estimate using information from the Department and the State Classification Office. Auditors based the cost of hiring more brokers on the average salary the Department pays an employee classified as a Financial Examiner I and added 28.29 percent to estimate the cost of employee benefits. Additional costs, such as travel, training, telephone, consumables, and information technology are not included. Auditors estimated the cost to licensees by taking the estimated cost of additional mortgage broker examiners and dividing it by the estimated number of licensees renewing annually.

Criteria used included the following:

- National State Auditors Association, *Carrying Out a State Regulatory Program*, 2004.
- Texas Finance Code, Chapter 156 (also known as the Mortgage Brokers License Act) and Texas Finance Code, Chapter 157.
- Title 7, Texas Administrative Code, Chapter 80.

- General Appropriations Acts and riders for fiscal years 2000 through 2006.
- Department policies and procedures.
- Control Objectives for Information and related Technology (COBIT), Information Systems Audit and Control Association.

Project Information

Audit fieldwork was conducted from November 2006 through January 2007. This audit was conducted in accordance with generally accepted government auditing standards.

The following members of the State Auditor's staff performed the audit:

- Walton Persons, CPA (Project Manager)
- John Swinton, CGFM, MPAff (Assistant Project Manager)
- Stephen J. Randall, MBA
- Tony White
- Dorvin Handrick, CISA, CDP (Information Systems Audit Team)
- J. Scott Killingsworth, CIA, CGFM (Quality Control Reviewer)
- John Young, CGAP, MPAff (Audit Manager)

Definition of Predatory Mortgage Lending Practices

The State Auditor's Office developed the following definition of predatory mortgage lending practices to use as criteria for this audit to (1) compare and evaluate the Department of Savings and Mortgage Lending's (Department) performance and (2) provide a context for understanding the results of the audit. Auditors developed this definition based on information from the National Conference of State Legislatures, the Center for Responsible Lending, and other sources. The Department reviewed and provided suggestions for the definition.

For purposes of this report, a predatory mortgage lending practice is defined as a mortgage loan transaction that exhibits one or more of the following characteristics:

- **Excessive fees.** These are fees beyond those necessary to cover costs and reasonable, risk-adjusted returns. Fees totaling more than 5 percent of the loan amount are common in predatory loans.
- **Lending without regard to the borrower's ability to repay.** These may include the use of non-traditional mortgage products.²
- **Bait and Switch.** This includes initially offering loans featuring low-interest rates, closing costs, and other fees to attract clients, and then substituting loans with terms significantly less favorable to the consumer prior to closing.
- **Loan flipping.** This is the refinancing of a loan to generate fee income without providing any net tangible benefit to the borrower.
- **High-pressure marketing.** This is predatory if the marketing seeks to mislead and exploit unsophisticated consumers.
- **Selling and financing unnecessary products.** An example is credit life insurance.³

² Examples of non-traditional mortgage products include, but are not limited to, payment-option adjustable-rate mortgages, interest-only mortgages, and negative-amortization mortgages.

³ According to the National Conference of State Legislatures, 17 states have banned the financing of credit life insurance.

The Role of Mortgage Brokers and Regulatory State Agencies in the Mortgage Lending Process

A mortgage broker is an intermediary between a borrower and a lender in the making of a mortgage loan. Below is a brief description of the roles of mortgage brokers, loan officers, mortgage bankers, exempt entities, and the state agencies that regulate mortgage lending.

Department of Savings and Mortgage Lending

The Department of Savings and Mortgage Lending (Department) licenses mortgage brokers and loan officers who make or arrange first-lien mortgage loans. It does this according to the provisions of the Mortgage Broker License Act, which specifies that:

- A "mortgage broker" is a person who receives an application from a prospective borrower for the purposes of making a mortgage loan from that person's own funds or from the funds of another person.
- A "loan officer" is an individual sponsored by a licensed mortgage broker for the purposes of performing the acts of a mortgage broker.

The Department also registers non-exempt mortgage bankers. (See exemptions listed below.) Under the Mortgage Broker License Act, a "mortgage banker" is a person who is:

- Approved or authorized by the U. S. Department of Housing and Urban Development (HUD) as a mortgagee with direct endorsement underwriting authority;
- An approved seller or servicer of the Federal National Mortgage Association;
- An approved seller or servicer of the Federal Home Loan Mortgage Association; or
- An approved issuer for the Governmental National Mortgage Association.

Mortgage brokers and loan officers who work for registered bankers are not required to be licensed.

Exemptions

A mortgage lender is exempt from the Mortgage Broker License Act under the following circumstances:

- Any of the following entities or an employee of any of the following entities provided the employee is acting for the benefit of the employer:
 - (A) A bank, savings bank, or savings and loan association, or a subsidiary or an affiliate of a bank, savings bank, or savings and loan association;
 - (B) A state or federal credit union, or a subsidiary, affiliate, or credit union service organization of a state or federal credit union;
 - (C) An insurance company licensed or authorized to do business in this state under the Texas Insurance Code;
 - (D) A mortgage banker registered under Chapter 157, Texas Finance Code.
 - (E) An organization that qualifies for an exemption from state franchise and sales tax as a 501(c)(3) organization;
 - (F) A Farm Credit System institution; or
 - (G) A political subdivision of this state involved in affordable home ownership programs.
- An individual who makes a mortgage loan from the individual's own funds to a spouse, former spouse, or persons in the lineal line of consanguinity of the individual lending the money.
- An owner of real property who makes a mortgage loan to a purchaser of the property for all or part of the purchase price of the real estate against which the mortgage is secured.
- An individual who:
 - (A) Makes a mortgage loan from the individual's own funds;
 - (B) Is not an authorized lender under Chapter 342, Texas Finance Code; and
 - (C) Does not regularly engage in the business of making or brokering mortgage loans.

Office of Consumer Credit Commissioner

The Office of Consumer Credit Commissioner licenses mortgage brokers who arrange second-lien mortgages with effective rates greater than 10 percent. It licenses mortgage lenders who make home equity loans (unless made with unsupervised HUD-approved lenders) or engage in second-lien mortgages. It licenses second-lien mortgage lenders.

Mortgage Broker Regulations in Texas and Other States

Table 2 summarizes regulations on mortgage brokers and predatory lending practices in Texas and other states. This table was created by the National Conference of State Legislatures and is reprinted with its permission.

Table 2

Mortgage Broker Regulations in Texas and Other States							
State	Statutory Citations	Flipping Banned	Negative Amortization Banned	Prepayment Penalties Banned	Financing Credit Insurance Banned	Consumer Credit Counseling Provisions	High Debt to Income Ratio Provision (Ability to Repay Loan)
Alabama	Ark. Stat. Ann. §23-53-101 <i>et seq.</i>						
Arkansas	Ark. Stat. Ann. §23-53-101 <i>et seq.</i>	X	X		X	Third- party required	Give due regard
California	Cal. Finance Code §4970 <i>et seq.</i> and §4973 <i>et seq.</i>	X	X			Disclosure	Presumption at 55 percent
Colorado	Colo. Rev. Stat. §5-3.5-101 <i>et seq.</i> and §38-40-105	X	X			Notification	Give due regard
Connecticut	Conn. Gen. Stat. §36a-746 <i>et seq.</i> and §36a-521		X			Notification	Presumption at 50 percent
District of Columbia	D.C. Code Ann. §26-1114. and §26-1151.01 <i>et seq.</i>		X	X			Give due regard
Florida	Fla. Stat. §494.0078 <i>et seq.</i>	X	X			Notification	Give due regard
Georgia	Ga. Code §7-6A-1 <i>et seq.</i>	X	X		X	Third- party required	Presumption at 50 percent
Illinois	Ill. Rev. Stat. ch. 815, 137/1 <i>et seq.</i> and ch. 765, 77/70	X	X		X	Notification	Presumption at 50 percent
Indiana	Ind. Code 4-6-12 and 24-9-1 <i>et seq.</i>		X		X	Third- party required	Give due regard
Kentucky	Ky. Rev. Stat. §294.010 <i>et seq.</i> and §360.100	X	X		X	Notification	Presumption at 50 percent
Louisiana	La. Rev. Stat. Ann. 6:1096(G) and 9:3572.6(C)						
Maine	Me. Rev. Stat. Ann. tit. 9-A, §2-509, tit. 9-B, §429; tit. 9-A, §8-103, §8-206-A, tit. 9-A, §10-102 and tit. 33, §506		X				Give due regard

Mortgage Broker Regulations in Texas and Other States

State	Statutory Citations	Flipping Banned	Negative Amortization Banned	Prepayment Penalties Banned	Financing Credit Insurance Banned	Consumer Credit Counseling Provisions	High Debt to Income Ratio Provision (Ability to Repay Loan)
Maryland	Md. Commercial Law Code §12-127, 12-311, 12-409.1 and 12-1029	X	X		X	Third- party required	Presumption at 45 percent
Massachusetts	Mass. Gen. Laws Ann. ch.183, 28C		X	X		Third- party required	Presumption at 50 percent
Michigan	Mich. Comp. Laws §445.1631 <i>et seq.</i>		X		X	Notification	
Minnesota	Minn. Stat. §58.137					Notification	
Missouri	Mo. Rev. Stat. 375.937						
Montana	Mont. Code Ann. §32-5-306						
Nebraska	Neb. Rev. Stat. §45-702, 45-704 and 45-705						
Nevada	Nev. Rev. Stat. §598D.010 <i>et seq.</i>			X	X		Give due regard
New Hampshire	N.H. Rev. Stat. Ann.140:1 <i>et seq.</i>						Give due regard
New Jersey	N.J. Rev. Stat. 46:10B-22 <i>et seq.</i>		X		X	Third- party required	
New Mexico	N.M. Stat. Ann. §58-21A-1 <i>et seq.</i>	X	X	X	X	Third- party required	Give due regard
New York	N.Y. Banking Law 6-l	X	X		X	Notification	Give due regard
North Carolina	N.C. Gen. Stat. §24-1.1E and §24-10.2 and §53-243.01 <i>et seq.</i>	X	X			Third- party required	Presumption at 50 percent
Ohio	2006 S.B. 187 Ohio Rev. Code Ann. §1322.062, 1322.07 and 1322.08	X	X	X	X		Give due regard
Oklahoma	Okla. Stat. tit. 14A, §3-204 and tit. 59, §2081 <i>et seq.</i>	X					Give due regard
Pennsylvania	Pa. Cons. Stat. 63, §456.101 <i>et seq.</i>					Notification	Presumption at 50 percent
Rhode Island	2006 Chapter 569 & 573 R.I. Gen. Laws §34-23-5 R.I. Gen. Laws §34-25.2-1 <i>et seq.</i>	X	X		X	Third- party required	Presumption at 50 percent
South Carolina	S.C. Code Ann. §37-23-10 <i>et seq.</i>	X	X		X	Third- party required	Presumption at 50 percent

Mortgage Broker Regulations in Texas and Other States

State	Statutory Citations	Flipping Banned	Negative Amortization Banned	Prepayment Penalties Banned	Financing Credit Insurance Banned	Consumer Credit Counseling Provisions	High Debt to Income Ratio Provision (Ability to Repay Loan)
Tennessee	2006 Public Chapter 801	X					Presumption at 50 percent
Texas	Tex. Finance Code §343.001 <i>et seq.</i> and Tex. Gov. Code §2306.001 <i>et seq.</i>		X ^a	X ^b			Give due regard ^c
Utah	Utah Code Ann. §61-2d-101 <i>et seq.</i>		X		X	Notification	
Virginia	Va. Code §6.1-422.1 and §6.1-422	X					
Washington	Wash. Rev. Code §31.04 <i>et seq.</i>						
West Virginia	W. Va. Code §31-17-1 <i>et seq.</i>						
Wisconsin	Wis. Stat. Ann. §428.202 <i>et seq.</i>	X	X		X	Notification	Give due regard

^a Texas Finance Code, Section 343.203, prohibits negative amortization on high-cost home loans, except in certain situations. Texas Finance Code, Section 343.201, defines a “high-cost home loan.”

^b Section 50, Article XVI, Texas Constitution prohibits prepayment penalties on home equity loans. Texas Finance Code, Section 343.205, prohibits prepayment penalties on high-cost home loans.

^c Texas Finance Code, Section 343.202, prohibits lenders from making high-cost home loans without regard to the obligor's repayment ability.

Source: National Conference of State Legislatures.

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair
The Honorable Tom Craddick, Speaker of the House, Joint Chair
The Honorable Steve Ogden, Senate Finance Committee
The Honorable Thomas “Tommy” Williams, Member, Texas Senate
The Honorable Warren Chisum, House Appropriations Committee
The Honorable Jim Keffer, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

Department of Savings and Mortgage Lending

Mr. Danny Payne, Commissioner

Finance Commission

Members of the Finance Commission

Mr. John L. Snider, Chair
Mr. Gary Akright
Mr. Mike Bradford
Mr. Hector Delgado
Mr. Vidal Gonzalez
Mr. Kenneth Harris
Ms. Cindy Lyons
Mr. Allan Polunsky
Mr. Bill White
Mr. Randall James, Executive Director



This document is not copyrighted. Readers may make additional copies of this report as needed. In addition, most State Auditor's Office reports may be downloaded from our Web site: www.sao.state.tx.us.

In compliance with the Americans with Disabilities Act, this document may also be requested in alternative formats. To do so, contact our report request line at (512) 936-9880 (Voice), (512) 936-9400 (FAX), 1-800-RELAY-TX (TDD), or visit the Robert E. Johnson Building, 1501 North Congress Avenue, Suite 4.224, Austin, Texas 78701.

The State Auditor's Office is an equal opportunity employer and does not discriminate on the basis of race, color, religion, sex, national origin, age, or disability in employment or in the provision of services, programs, or activities.

To report waste, fraud, or abuse in state government call the SAO Hotline: 1-800-TX-AUDIT.