SW&M FINANCIAL INSTITUTION ATTORNEYS

Legal Issues Bulletin

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Liquidity, Liquidity, Liquidity…

… the most common refrain from our clients. Has it only been a month and a half since the failure of Silicon Valley Bank? While many commentators are trying to convince the country that liquidity crises are over with JP Morgan Chase's recent assumption of First Republic Bank, we believe it would be foolish for financial institutions to ignore the economic pressures and worries that brought down these institutions.

We wrote about some of the lessons learned on our newly relaunched blog (SWM Lessons), at https://swmllp.com/bank-failures/. Lessons learned include:

- Analyze uninsured deposits, including reporting to the Board on levels of uninsured deposits and their characteristics (depositor types, perceived rate sensitivity, etc.).
- Engage with consumer depositors about uninsured deposits. Consumers can more easily structure for higher deposit insurance than businesses.
- If you have high levels of business uninsured deposits, look at sweep programs (subject to liquidity).
- Review liquidity, including contingency funding plans. Non-guaranteed lines can, in a credit crisis, be pulled when you least expect and most need them. The regulators will be reviewing cash + short term assets to total assets ratios and admonishing those below 10%.
- Review practices regarding collateral. Many financial institutions are supported by FHLB lines. FHLB has recently been "cracking down" on servicing practices on pledged loans, most particularly modifications using electronic signatures. While electronic signatures on modifications became an effective accommodation during COVID, the FHLB's guidelines for pledged collateral exclude loans with such modifications, even if they would not be required to be recorded (e.g., rate only mods). Lenders relying on FHLB San Francisco (and potentially others) should stop accepting electronic signatures on modifications.
- Monitor relationships with FinTechs, particularly loan servicers. Where servicers are supported by banks, subject to public company reporting (or even normal call reporting) and the influence of news cycles, modern runs remain increasingly possible. Interest rate risk can still "spook" investors, causing ripples through a balance sheet, and ultimately the types of runs that brought down SVB and First Republic. Servicing funds can be significant, and can be temporarily in pooled accounts, diluting insurance protections. Review how your servicing funds are held, and their "velocity" through the bank to you. The less time they are in pooled accounts, or between receipt and transmission/processing, the better.
- Review "held for sale" and "held to maturity" practices to avoid mark-to-market surprises.

Examiners commonly continue to fight their last war. This liquidity issue (whether a protracted crisis or not) will show up in examinations in the future.

"For Informational Purposes Only" in a Notice Sent to a Debtor in Bankruptcy is not a Cure All

Upon the filing of a bankruptcy case, the automatic stay (an automatic springing injunction) goes into place and prohibits attempting to collect on pre-petition (i.e., pre-bankruptcy filing) debt. So, when sending ongoing statements to someone in bankruptcy, creditors generally include bankruptcy-specific disclaimers that include, at a minimum, assertions that the statement is being provided for informational purposes only and is not an attempt to collect pre-petition debt. However, those statements are not a cure-all, and if the periodic statement provided is inconsistent with those disclaimers, a court may find that the statement violates the automatic stay.

The Ninth Circuit Bankruptcy Appellate Court (the "BAP"), which handles appeals arising from bankruptcy proceedings in the Western states and territories, recently held that a loan servicer who issued a mortgage statement including $950 in the pre-petition charges in the amount of the next post-petition payment had violated the automatic stay despite the inclusion of bankruptcy disclaimers. The BAP said that it would not have found the statement to be a stay violation if the $950 had been separated out as pre-petition arrears instead of included in the amount due for the next post-petition payment, concluding that it is the creditor's

responsibility to ensure that post-petition communications are clear about not trying to collect pre-petition debt.

Statements (and other post-petition communications) should be holistically reviewed to ensure that the presentation of amounts statement separates out pre-petition arrears from post-petition debt and does not include the arrears in the monthly amount to be paid post-petition. Disclaimers are not enough. This is particularly important, as we head toward an expected wave of consumer filings.

4th Circuit Sides with Lenders on MLA Exemption

The saga of the Military Lending Act and financed insurance products continues, but with a "win" for lenders this time. The Fourth Circuit federal appellate court recently ruled that a vehicle purchase money loan that also financed a GAP product is exempt from the scope of the MLA. In this case, a servicemember borrowed money to finance the purchase of a vehicle. The loan contract, which also financed GAP, included a mandatory arbitration provision, which is prohibited by the MLA. After a lower court ruled that the loan was exempt from the MLA, the plaintiff appealed, and the CFPB, DOD, and DOJ filed an amicus brief on the plaintiff's behalf, arguing that the MLA should be interpreted to cover "hybrid" type loans that finance credit related products such as GAP. The Fourth Circuit rejected the government's interpretation, ruling that the language of the MLA, which exempts vehicle secured loans that are offered "for the express purpose of financing" the purchase of the vehicle, requires an exemption of loans that are offered for the "specific," not "sole," purpose of financing the vehicle. In the court's opinion, the fact that there were other purposes for the loan did not remove the loan from the exemption. It remains to be seen what impact this court's decision will have on the enforcement of the MLA outside of the Fourth Circuit (Maryland, North Carolina, South Carolina, Virginia, and West Virginia).

CFPB Advisory Opinion on RESPA Section 8

The CFPB issued an Advisory Opinion in February of 2023, which addressed the applicability of RESPA section 8 to operators of certain digital technology platforms that enable consumers to comparison shop for mortgages and other real estate settlement services.

The Advisory Opinion stated that an operator of such platforms receives a prohibited referral fee in violation of RESPA section 8 when: (1) the Digital Mortgage Comparison Shopping Platform non-neutrally uses or presents information about one or more settlement service providers participating on the platform; (2) that non-neutral use or presentation of information has the effect of steering the consumer to use, or otherwise affirmatively influences the selection of, those settlement service providers, thus constituting referral activity; and (3) the operator receives a payment or other thing of value that is, at least in part, for that referral activity. The CFPB indicated that this activity could also potentially implicate the Dodd-Frank Act's prohibition on UDAAP.

Given the lack of regulatory guidance in this regard, financial institutions who work with such operators should familiarize themselves with this Advisory Opinion, including the provided examples, to determine whether or not their business arrangements and related agreements with these Providers are compliant with RESPA. Importantly, this Advisory Opinion appears to signal that the CFPB and other regulators will be taking a closer look at such operators and ramping up their RESPA Section 8 enforcement, given the rising interest rate market and the overall increase in the cost of homes.

Enforcement Efforts Against Discrimination and Bias in Automated Systems

On April 25, 2023, the CFPB and three other federal agencies released a joint statement with warnings about responsible innovation in automated systems. The FTC cautioned, "We already see how AI tools can turbocharge fraud and automate discrimination, and we won't hesitate to use the full scope of our legal authorities to protect Americans from these threats." The joint statement advises market participants to critically evaluate automated systems that rely on vast amounts of data to find patterns or correlations, and then apply those patterns to new data to perform tasks or make recommendations and predictions. Examples provided in the joint statement include cautioning market participants that (i) automated systems can correlate data with protected classes, which can lead to discriminatory outcomes; (ii) many automated systems are "black boxes" whose internal workings are not clear to most people and, in some cases, even the developer of the tool; and (iii) developers do not always understand or account for the contexts in which private or public entities will use their automated systems. The regulators also made clear that the fact that the technology used to make a credit decision is too complex, opaque, or new is not a defense for violating adverse action or other consumer financial protection laws.

In particular, we have recently seen a number of institutions get tripped up by using age as a factor that shifts automobile lending from automated decisioning to manual decisioning. Note that any difference in treatment, even if it doesn't result in different credit decision outcomes, will be seen as violating Reg. B and as unfair, if based on a protected class.

Accordingly, financial institutions should exercise caution and regularly evaluate their use of automated systems for underwriting and/or credit decisions to avoid discriminatory outcomes and adverse regulatory action.