Protecting Homeownership, Reforming the Marketplace: The California Legislature's Role in Today's Crisis

Our nation's current economic crisis was driven by, among other things, three significant shortcomings in the mortgage system: 1) loose or nonexistent underwriting standards; 2) misplaced financial incentives that created conflicts between industry profits and borrowers' interests; and 3) lack of accountability among industry players for loan quality or performance. Given this systemic failure, the State should step in to limit spiraling foreclosures and to reform regulations for new lending. State lawmakers should both act at the state level and also encourage federal policymakers to act to keep borrowers in their homes, thereby preserving home equity (and property tax revenues) and stabilizing the California economy. Moreover, with 60 percent of subprime loans originated by state-regulated lenders in 2006, and as many as 75% of subprime loans arranged by state-regulated mortgage brokers, it is imperative that California strengthen its reform of these state-licensed players by expressly addressing the market failures that have led to this crisis.

POLICY OBJECTIVE #1
Mitigate the number and impact of foreclosures.

Background

Approximately 85,000 California homes were lost to foreclosure in 2007.[1] In the first three quarters of 2008 alone, that number skyrocketed to 189,793 completed foreclosures.[2] At this pace, California is on track to see 300,000 or more foreclosures in 2009. The impacts of foreclosure are not limited to homeowners who lose their homes. According to research by the Center for Responsible Lending (CRL), more than 7 million California families who are paying their mortgages will lose over $100 billion in home equity solely due to foreclosures in their neighborhoods.[3] Neighborhoods experience increasing blight and crime as the number of empty or abandoned houses rise and the economy continues to decline. The reduction in property values erodes the tax base from which local, regional and state governments are funded. The crisis also significantly impacts the California housing market and economy. As of October 2008, the median home price in California – $278,000 – was down 43% from its peak of $484,000, and down 34.4% from October 2007.[4] Additionally, California's $40+ billion budget shortfall is due in part to reduced tax revenues, and other effects of the foreclosure-induced credit crunch and economic slowdown. The most urgently needed actions right now are those that will, in the very near-term, stop the vicious cycle of falling home values and foreclosures.

Recommended Actions

CRL urges the Legislature and the Governor to do the following:

A. Enact foreclosure-prevention legislation that requires or incentivizes mortgage servicers to adopt streamlined loan modification programs with affordability requirements, designed to keep borrowers in their homes with sustainable mortgages.

B. Require by statute or regulation that mortgage servicers provide detailed reporting on their loss mitigation efforts and outcomes, and publicize that data on a company-specific basis.

C. Enact legislation that requires entities to provide proof of ownership of the mortgage note and their authority to foreclose on the borrower before moving to foreclose.

D. Advocate through a Resolution or otherwise that the U.S. Treasury embark on a concentrated, multi-pronged effort to increase affordable loan modifications made through the Troubled Asset Relief Program (TARP).

E. Advocate through a Resolution or otherwise that Congress and the President close the bankruptcy loophole and allow federal bankruptcy judges to modify the mortgage loan on a person's primary residence in bankruptcy, and prevent hundreds of thousands of foreclosures.

POLICY OBJECTIVE #2

Reform the mortgage system, increase consumer protections and improve enforcement.

Background

Existing California "predatory lending" law applies only to the highest cost mortgages (few of which have been made in recent years), and other California law regulates little, if any, of the mortgage market. The record foreclosure levels in California, however, are concentrated in the subprime and nontraditional (Alt-A) markets.[5] Recent federal regulations apply only to "higher-priced" mortgages, which generally include subprime loans, but the regulations leave out risky nontraditional mortgages. Moreover, the "guidelines" that California adopted with respect to nontraditional mortgages have no enforcement mechanism. Given California's significant national market share of risky nontraditional loans (in the range of 50% or more), it is all the more important that real reform measures *and* enforcement mechanisms include nontraditional loans.[6] Similarly, Department of Real Estate-licensed mortgage brokers, who played a significant role in the mortgage boom and bust, have had little regulation and less enforcement. For example, these brokers are not required to place a bond or show a minimum financial net worth for licensing, one of only a handful of states without such a requirement.

Recommended Actions

CRL urges the Legislature and the Governor to do the following:

A. Require that recently expanded federal regulatory protections cover nontraditional mortgage loans in California. These regulations would include basic requirements like evaluating the borrower's ability to repay the loan at full interest rates (not the teaser rates), verifying borrower income, limiting prepayment penalties, and requiring borrowers to make escrow payments for insurance and taxes.

B. Enact legislation to regulate mortgage brokers that would eliminate misaligned incentives and strengthen protections, including 1) imposing strict duties on brokers (including a fiduciary duty); 2) banning yield spread premiums (kickbacks from lenders to brokers for placing borrowers in higher cost loans) on subprime and nontraditional loans; 3) prohibiting brokers from steering borrowers to loans that are more costly than those for which they qualify; 4) imposing a loan suitability-type requirement; and 5) establishing a bond requirement.

C. Enact legislation to prohibit prepayment penalties from all subprime loans. These fees serve to trap families in bad loans, penalize them for improving their credit record, and strip their equity.

D. Enact legislation that includes strong enforcement mechanisms in California, including local enforcement authority, and allowing harmed borrowers to enforce violations and seek redress.

E. Advocate that Congress pass a strong predatory lending bill, like S. 2452 (Dodd).

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[1] The total number of recorded Trustee Deeds for 2007 in California according to DataQuick was 84,375, based on combining the quarterly reports. *See generally* www.dqnews.com.

[2] The total number of recorded Trustee Deeds for the first 3 quarters of 2008 in California was 189,793, based on combining the quarterly reports. *See generally* www.dqnews.com.

[3] "Updated Projections of Subprime Foreclosures in the United States and Their Impact on Home Values and Communities" at 2 (Center for Responsible Lending Aug. 2008), available http://www.responsiblelending.org/pdfs/updated-foreclosure-and-spillover-brief-8-18.pdf.

[4] *See* Data Quick, California October 2008 Home Sales (Nov. 20, 2008), available at http://www.dqnews.com/News/California/RRCA081120.aspx; DataQuick, California September 2007 Home Sales (Oct. 19, 2007), available at http://archive.dqnews.com/RRCA1007.shtm.

[5] In California, while subprime loans represent 12.5% of outstanding mortgages, they accounted for 55% of the foreclosure inventory at the end of 3Q 2008. CRL calculations based on MBA National Delinquency Survey, 3rd Quarter, 2008. *See also* "Second Wave Of Mortgage Defaults On The Horizon?," *60 Minutes* (Dec. 14, 2008), available at http://www.cbsnews.com/stories/2008/12/12/60minutes/main4666112.shtml (transcript); "Assessing Risks to Global Financial Stability," at 8, Fig. 1.7 (Credit Suisse monthly mortgage rate rests by loan type), available at http://www.imf.org/external/pubs/ft/gfsr/2007/02/pdf/chap1.pdf

[6] Alt-A or nontraditional mortgages include mortgages that are structured to defer payments of interest or principal, and include interest only loans and payment option ARMs. California held 44.8% of all such mortgages as of 3Q 2007, 56.7% of all payment option ARMs and 44.1% of all interest only ARMs. (Source: Inside Alternative Mortgages, Nov. 9, 2007).