CENTER FOR RESPONSIBLE LENDING

California Senate Banking Committee Informational Hearing
Preserving the American Dream:
Home Ownership and the Subprime Mortgage Crisis
August 21, 2007

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Introduction

First, I wish to thank Senator Machado and his colleagues on the Senate Banking Committee for convening today's informational hearing, and for inviting the Center for Responsible Lending to testify.

I want to make three main points today.

First, California has seriously lagged behind other states in its response to the meltdown in the mortgage market.

Second, there are a number of concrete steps that California can take today to minimize foreclosures and stabilize housing markets, including providing emergency funding for foreclosure prevention counseling and legal assistance, establishing a strong monitoring system for loan modifications, and a targeted refinance product to help borrowers refinance loans contingent on lender preconditions.

Third, California should enact comprehensive changes to return subprime lending to more responsible standards, including requiring lenders to evaluate the borrower's ability to repay their loans, eliminating risky product features for subprime borrowers and making structural changes in the roles of lenders, brokers and investors in the origination of mortgages.

I. California Lags Other States in Responding to the Foreclosure Crisis

There is an urgent need to address the epidemic of foreclosures in the subprime market today—the highest rate of home losses in the modern mortgage era. While other states have taken steps to raise standards on subprime lending and bold steps to prevent foreclosures, <u>California's efforts to address rising foreclosures have lagged considerably</u>. California's existing anti-predatory lending law is weaker than most states that have enacted these types of laws. The negative effects of subprime foreclosures are particularly serious for California:

- About one quarter of all subprime lending in the nation occurs in California.
- Foreclosures in California in the second quarter reached their highest level since 1988.

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- The worst is yet to come: According to Moody's Economy.com, more than two million subprime adjustable rate mortgages will be resetting later this year, with an estimated $50 billion worth of mortgages due for reset in October 2007 alone.[1]
- CRL estimates that more than one in five (21.4%) subprime loans originated in California in 2005 and 2006 will end in a foreclosure.[2] We estimate that nearly 500,000 Californians will lose their homes because of subprime loans originated since 1998.

In November 2006, the federal bank regulatory agencies finalized new guidance governing underwriting practices and disclosure requirements for banks and other federally-insured depository institutions that make "non-traditional" mortgages. Thirty-six states have already implemented similar guidance for their state-regulated lenders and brokers. By contrast, California regulators needed the threat of legislation to spur the drafting of regulations, which were not released for public comment until late April 2007, and have not yet been finalized.

This is the Committee's third informational hearing on issues related to the collapse of the subprime mortgage market.[3] While states like Maine, Minnesota and North Carolina have enacted strong and bold legislation to supplement federal guidance, California has not enacted any regulatory or statutory change to help or protect California borrowers in this period. We hope that today's hearing will spur the Legislature act swiftly to assist current subprime borrowers in trouble and provide adequate protections for borrowers in the future.

We propose the state take immediate in the following areas, summarized in more detail below:

Assist Current Subprime Borrowers

- Emergency Funding for Foreclosure Prevention Counseling and Legal Services
- Monitoring Private Loan Modification Efforts—Including State Data Collection and Tracking

Protect All New Subprime Borrowers

- Ban Prepayment Penalties on All Subprime Loans
- Establish Statutory Standards for Ability to Repay: All mortgage originators should assess the ability of borrowers to repay their loan, based on the fully-indexed interest rate and fully amortized payments and with a limit on the debt-to-income ratio that is assumed.
- Require Appropriate Documentation of Income
- Require Mandatory Impoundment (or Escrow) of Property Taxes and Hazard Insurance
- Establish Lender Liability for Broker Acts and Omissions When Yield Spread Premiums are Charged

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[1] http://money.cnn.com/2007/07/09/real_estate/resets_are_coming/index.htm

[2] *Losing Ground, Foreclosures in Subprime Market and Their Cost to Homeowners*, The Center for Responsible Lending, December, 2006. Available at: http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189.

[3] Prior hearings were held January 31, 2007 and March 26, 2007.

II. California Can Help Borrowers Avoid Foreclosure

Providing some assistance and relief to current borrowers faced with defaults and foreclosures is a pressing priority. We propose three strategies for the state to implement: emergency funding support for foreclosure prevention counseling and legal services; creation of a monitoring system for lender loan modifications; and a targeted refinance product for borrowers who would not qualify for refinance or modifications.

1.) Emergency Support for Foreclosure Prevention Counseling and Legal Assistance: Housing counseling agencies are already stretched to the limit in responding to this foreclosure crisis. The national hotline – **-888-995-HOPE** -- that was created to assist borrowers with their mortgage problems is now receiving more than 2,000 California calls per month, the heaviest volumes in the country. This hotline provides a 24-hour resource where borrowers can call to get an honest and frank assessment of their situation, advice about when it makes sense to negotiate with servicers for a loan modification or some other form of relief, and referrals to local housing counseling agencies or legal service providers.

Housing counseling agencies and legal service providers can be critical assets for borrowers, but their limited resources are swamped attempting to assist needy borrowers. These agencies provide critical support for borrowers in navigating the complex process of negotiating with servicers through the loss mitigation process. Having a knowledgeable “trusted adviser” who has no financial stake in the outcome a borrower’s negotiation can balance the knowledge gap between a professional servicer and less-knowledgeable borrowers.

Moreover, many borrowers may be victims of illegal practices and need the services of a lawyer. There are extremely few lawyers working in the state who can afford to represent individual clients with mortgage cases. The cases are often complex and time-consuming and frequently damages may not include lawyers fees.

California only receives approximately $3 million in federal counseling assistance funding and most of these resources are directed at activities to assist first-time homebuyers prepare for purchasing their homes.

California should appropriate an emergency supplement of $5-$10 million, enacted and disbursed as soon as possible to provide borrowers with critical assistance necessary to save their homes.

2.) Making Loan Modifications Work: Loan modifications offer the most promising alternative for both borrowers, taxpayers and the healthy functioning of mortgage markets in the future.

For borrowers, modifications offer the opportunity to keep them in their homes – ideally with long-term affordable mortgages. The best modifications will convert the existing adjustable rate mortgage to a long-term fixed rate mortgage at the original introductory interest rate for the life of the loan. This type of adjustment should be sufficient to achieve affordability for borrowers in markets that have not experienced significant price declines. Moreover, these initial rates were already risk-adjusted and substantially exceeded prime rates.

For borrowers in markets with steep price declines, deeper modifications may be necessary. For these borrowers, it may still be economically prudent for servicers to reduce the interest rate or the loan balance, rather than face the even higher costs of foreclosures.

For taxpayers, modifications minimize the negative consequences of foreclosures and avoid large infusions of taxpayer subsidies to avoid them. Specifically, concentrated foreclosures serve to depress the prices of nearby houses. Researchers have found that in Chicago a foreclosure on a home lowered the price of other nearby single-family homes, on average, by 1.44 percent. They also reported that the downward pressure on housing prices extended to houses that sold within two years of the foreclosure of a nearby house.[4] Concentrated foreclosures can also lead to higher municipal costs, as local governments step in to maintain the security and appearance of vacant homes in their communities.[5]

In addition, wide utilization of modifications can minimize the need for public resources to assist in providing affordable refinance options for subprime borrowers. To date, a number of states have announced new publicly-funded pools to fund refinance loans for borrowers at risk of foreclosure. States which have developed these funds include Ohio, New York, Massachussetts and Colorado.

For mortgage markets, modifications keep market incentives firmly in place. Modifications will ensure that losses are borne by the lenders and investors who are responsible for making loans without adequately evaluating the borrowers's ability to repay them. As long as the reduced cash flow of modifications exceeds the value likely to be recovered from a foreclosure, the losses are consistent with the servicers requirements to maximize cash flows for the investors in securities as a whole.

Obstacles to Modifications Are Being Removed, but Several Challenges Remain

There has been much confusion about how much latitude servicers have to modify mortgages. Securitization trusts establish the types, amounts and conditions for loan modifications under their Pooling and Servicing Agreements (PSAs) with their servicers. Credit Suisse recently reviewed a sample of 30 PSAs and concluded, "servicers generally have wide latitude with respect to loan modifications as well as other types of forgiveness."[6]

Many servicers and investors have identified a number of legal, accounting and tax issues that could prevent them from doing loan modifications at scale. However, each of these issues seems to have been resolved in a way that generally and in most PSAs does not prevent large-scale modifications. Moreover, even when there are limitations in the PSAs, it may be possible for them to be waived.[7]

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[4] Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," p. 57, 69, 72, 75 *Housing Policy Debate* (17:1) Fannie Mae Foundation (2006).
[5] Find Wall Street Journal story about Cleveland foreclosure costs.
[6] "The Day After Tomorrow: Payment Shock and Loan Modifcations," Credit Suisse Fixed Income Research, 05 April 2007. www.credit-suisse.com/researchandanalytics.
[7] Limitations on the number or volume of loan modifications allowed: Credit Suisse's survey found that only one-third of the PSAs reviewed put a loan or volume limitation on loan modifications, typically at 5 percent. However, these limitations can be waived with permission of certain outside parties (NIM insurer, rating agencies, or private mortgage insurers.)

Several issues continue to be challenges for large-scale loan modifications. Continuing national dialogue is underway to determine how to facilitate loan modifications where borrowers have first and second liens. While servicers are required to maximize revenues for investors, investors in certain classes or tranches of securities may be disadvantaged by the outcome of particular loan modifications. The servicers could face legal suits filed by investors.

Need for Accountability and Standardization and in Modifications

In preparation for the dramatic increases in loan resets, servicers are now expanding their loss mitigation efforts, adding staff and employing new efforts to contact borrowers early to prepare for the reset. The American Securitization Forum, an industry group has produced a *Statement of Principles, Recommendations and Guidelines on Modifications* to its members.[8]

While lenders profess a desire to avoid foreclosures, there are few mechanisms in place to track the outcomes for borrowers who participate in loss mitigation efforts. No data is regularly reported by lenders as to how many borrowers who participate in loss mitigation efforts avoid foreclosures, nor on the terms of the loan modifications they receive. The state could quickly establish a reporting and monitoring system for loans that are modified. This would greatly increase the accountability of servicers' loan modification efforts and allow the public and policymakers to track success and gain a greater understanding of which loss mitigation practices and servicers are most effective in achieving long-term affordability outcomes for borrowers.

State policymakers should also work with servicers to develop transparency and objective standards for loan modifications. Under current practice, each loan modification is developed on a case-by-case basis, subject to the financial circumstances of individual borrowers. There is little transparency for borrowers to know the best terms for which they could qualify and no guarantees that similarly situated borrowers will be treated equally. Having more streamlined and objective standards in place should simplify and streamline the modification process, and

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Timing of eligibility for modifications: some servicers have interpreted their PSAs to permit modifications only for borrowers in default. Many believed that modification before default might violate both tax and accounting rules. Both of these concerns have been addressed to allow servicers to modify loans when default is deemed to be "reasonably foreseeable" in advance of actual default.

Tax Benefits: Earlier this year, there were concerns that modification prior to default might violate the Real Estate Investment Mortgage Investment Conduit (REMIC) tax codes – and thus the substantial tax benefits -- under which most securitizations are structured. However, the IRS has now clarified that servicers may modify loans where default is "reasonably foreseeable."

FAS 140 Accounting Standards: A similar question about the timing of loan modifications has been raised with respect to accounting standards established by Financial Accounting Standards Board, under FAS 140, the specific standards that guide securitizations. A July 24, 2007 letter from Securities and Exchange Commission Chair Christopher Cox to House Financial Services Committee Chair states clearly that the Commission's professional staff believes that loan modifications undertaken when loan default is "reasonably foreseeable" should be consistent with . . . modification activities that would have been permitted if a default had occurred.

[8] American Securitization Forum, *Statement of Principles, Recommendations and Guidelines on Modifications,* June 2007 found at http://www.americansecuritization.com/uploadedFiles/ASF%20Subprime%20Loan%20Modification%20Principles_060107.pdf

allow more consistent and successful results for borrowers and lenders. These standards would also avoid potential fair housing issues.

In sum, the legislature or Governor should immediately establish a data and monitoring system to track foreclosures and the outcomes of loan modifications for at-risk borrowers.

3.) Developing a State-Backed Refinance Mechanism: As noted above, a number of states have utilized bond funds to develop refinancing products for borrowers at risk of foreclosures, including Massachussetts, New York, Colorado and Ohio. These pools are limited and are targeted to assist low income households. Other restrictions are also often applied: no investors are eligible and borrowers who have previously extracted equity through a refinancing would be prohibited. Many states are partnering with larger financial providers, like Fannie Mae and Freddie Mac, to allow their limited resources to serve more families.

Most importantly, it is critical that any state-backed resources be contingent upon significant financial concessions by the servicers and investor. Such resources should not be used to make investors whole, and thus serving to bail them out of bad investment decisions. These concessions could include refinancing at no more than 90 percent of the current appraised or even the estimated foreclosure value of the property, whichever is less.

The legislature should direct and fund the California Housing Finance Agency to develop a refinance product to assist at risk borrowers, contingent upon servicer/investor concessions.

III. Legislative Recommendations to Protect Future Borrowers

California appears to be following the federal regulators in establishing new lending standards for subprime loans. Other states have shown much greater leadership in both establishing tougher lending standards and in strengthening procedures to rein in deceptive practices of brokers and lenders. Much stronger legislative action is needed to ensure that subprime borrowers get access to responsible credit that provides sustainable homeownership opportunities.

1. <u>Ban Prepayment Penalties on Subprime Loans</u>

Prepayment penalties are minimally addressed in the subprime statement, requiring only a grace period of 60 days before payment reset, during which a borrower must be able to refinance without paying a prepayment penalty.

Subprime prepayment penalties provide no economic benefit to borrowers. Some lenders have claimed that homeowners receive a lower interest rate in exchange for prepayment penalties, but subprime lenders' rate sheets tell a different story. Subprime rate sheets show that when borrowers get loans with prepayment penalties, mortgage brokers are allowed an extra commission known as a "yield spread premium." Prepayment penalties can cost borrowers thousands of dollars if they pay their loan early, and yield spread premiums increase the costs of the loan as well.

In fact, prepayment penalties serve to trap borrowers in high cost loans, or cause the borrower to lose significant home equity in order to escape them. They also limit the ability of responsible lenders to help borrowers refinance out of a loan at risk of ending in foreclosure.

Today prepayment penalties are imposed on about 70 percent of all subprime loans,[9] compared to about 2% of prime loans.[10] This disparity undermines the argument that subprime borrowers freely "choose" prepayment penalties. The unfairness of prepayment penalties is even more disturbing when you consider that they are more prevalent on subprime loans in communities of color. Borrowers in minority neighborhoods are more likely to receive prepayment penalties,[11] and minorities are at greater risk for receiving higher-priced loans than white borrowers, after controlling for legitimate risk factors.[12]

More than 35 states now regulate prepayment penalties, and at least ten states ban them outright. The recent trend is to ban prepayment penalties in the subprime market. North Carolina and Minnesota just banned prepayment penalties in subprime loans.

Like Minnesota, Maine and North Carolina, California should ban prepayment penalties for all subprime loans.

2. <u>Establish Legislative Ability to Repay Standards</u>

Approving loans without evaluating a borrower's ability to repay is an unfair and deceptive practice because borrowers are deceived into thinking that they can afford the loans, and they are subjected to the ultimate of injuries – the loss of their home and hard-earned equity – when rates increase, as scheduled, after two or three years. The federal regulatory subprime statement sets out some basic guidance which while stronger than current regulatory standards provides only regulatory guidance. It is not clear that the state will have adequate capacity to enforce the guidance and individual borrowers have limited access to remedies for the shortcomings of their brokers or lenders.

Moreover the guidance fails to establish any meaningful debt-to-income standards for underwriting loans. Lenders can legally circumvent the subprime statement's ability to pay standards by simply using more elastic (and increasingly unmanageable) debt-to-income ratios.

Stronger, enforceable statutory standards should be established.

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[9] *See, e.g.* David W. Berson, *Challenges and Emerging Risks in the Home Mortgage Business*: *Characteristics of Loans Backing Private Label Subprime ABS*, Presentation at the National Housing Forum, Office of Thrift Supervision (December 11, 2006). According to MBA data, there was a 69.2% penetration rate for prepayment penalties on subprime ARMs originated in 2006. Doug Duncan, *Sources and Implications of the Subprime Meltdown,* Manufactured Housing Institute, (July 13, 2007) A recent CRL review of 2007 securitizations showed a penetration rate for prepayment penalties averaging over 70%.

[10] *See* Berson, *supra* note 68**.** A recent MBA analysis shows that 97.6% of prime ARMs originated in 2006 had no prepayment penalty, and 99% of 2006 prime FRM had no penalty. Doug Duncan, *Sources and Implications of the Subprime Meltdown,* Manufactured Housing Institute, July 13, 2007

[11] Debbie Gruenstein Bocian and Richard Zhai, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans*, Center for Responsible Lending (January, 2005).

[12] Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending (May, 2006).

Lenders should be required to underwrite all loans based on the fully-indexed rate and fully amortizing payments, while using a debt-to-income standard (DTI) that considers property taxes, hazard insurance, and other debts. Maine, Minnesota, Ohio and North Carolina laws would serve as good models. In addition, this DTI standard should include a rebuttable presumption that the borrower had sufficient capacity to repay the loan where the lender could establish with documentation that the DTI was 50% of gross income or less.

3. Require Appropriate Documentation of Income

Verification of income is a necessary complement to effective implementation of an ability to pay standard. While lenders purport to evaluate borrowers and underwrite loans, in reality, without adequate income verification, a lender's approval of a loan is meaningless. Borrowers often do not understand that they are paying extra higher interest rate not to document their income, even though their W-2s are readily available, or that their income is overstated. Stated income loans also increase the interest rate borrowers pay for no reason and have been proven to overstate incomes, understate repayment ability, and therefore increase foreclosures. For example, a review of a sample of "stated-income" loans disclosed that 90 percent had inflated incomes compared to IRS documents, and "more disturbingly, almost 60 percent of the stated amounts were exaggerated by more than 50 percent."[13]

Fitch Ratings recently noted that "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector . . ."[14] "Low doc" and "no doc" loans originally were intended for use with the limited category of borrowers who are self-employed or whose incomes are otherwise legitimately not reported on a W-2 tax form, but lenders have increasingly used these loans to obscure violations of sound underwriting practices.

California should require lenders to verify and document all sources of income using either tax or payroll records, bank account statements or any reasonable alternative or third-party verification.

4. Require Impoundments (or Escrows) for Taxes and Insurance

In stark contrast to the prime mortgage market, most subprime lenders make loans based on low monthly payments that do not impound (or escrow) for property taxes or hazard insurance. By routinely omitting escrows for taxes and insurance, subprime lenders have deceived borrowers into believing that their mortgage will be affordable. This deceptive practice is also unfair, since borrowers are often required to refinance their mortgage to raise the funds to pay the required fees, needlessly causing substantial injuries of approximately 8% of the loan amount (3% in

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[13] Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006); *see also* 2007 Global Structured Finance Outlook: Economic and Sector-by Sector-analysis, FITCH RATINGS CREDIT POLICY (New York, N.Y), December 11, 2006, at 21, commenting that the use of subprime hybrid arms "poses a significant challenge to subprime collateral performance in 2007."

[14] See *Structured Finance: US Subprime RMBS in Structured Finance CDOs,* FITCH RATINGS CREDIT POLICY (New York, NY), August 21, 2006, at 4.

upfront points and fees, 2% in third party fees, 3% in prepayment penalties), or $24,000 for a $300,000 loan.

California statute should require that all subprime loans must both (A) include the cost of hazard insurance and property tax escrows in their ability to repay analysis of a subprime loan the cost of hazard insurance and property tax escrows and (B) establish escrow or impoundment accounts for such taxes and insurance.

5. Establish Lender Liability for Broker Acts and Omissions When Yield Spread Premiums are Charged

Finally, to effectively address subprime abuses, it is important to take a stronger approach to addressing the unfair and deceptive tactics that brokers use to push subprime refinances on borrowers. In today's marketplace, nearly three-quarters of subprime loans are brokered. California's current regulatory approach is complaint-driven and ineffective either in deterring broker malfeasance or in providing remedies to borrowers.

Experts on mortgage financing have long raised concerns about problems inherent in a market dominated by broker originations. For example, Federal Reserve Board Chairman Ben S. Bernanke recently noted that placing significant pricing discretion in the hands of financially motivated mortgage brokers in the sales of mortgage products can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws.[15]

Whether the lender directly originates an abusive loan or funds an abusive loan originated by a broker, the borrower suffers injury, and the lender gets the asset. Moreover, lenders, who are mortgage professionals themselves, as well as repeat users of brokers' services, have the expertise, the leverage and the capacity to exercise oversight of the brokers with whom they do business. Consumers do not. The costs of their failure to do so should therefore be borne by lenders, not borrowers

It is appropriate, therefore, to hold the lender responsible for abusive subprime loans, regardless of whether originated by the lender directly, or through the broker. Allowing lenders to obtain the benefit of broker misconduct without associated liability distorts the market and substantially undermines the effectiveness of any regulations. It would also leave borrowers without adequate remedies. Brokers are commonly thinly capitalized and transitory, leaving no assets for the borrower to recover against. Even more problematic are the hurdles that unclear lender liability creates as borrowers seek to defend foreclosures on the basis of origination improprieties.

This is true for all broker-originated loans and, to be effective, such provision should apply across the board for subprime loans. But there is even greater reason to codify lender liability where the lender pays the broker a yield spread premium. Such payments distort competitive market forces by creating a reverse competition effect – the broker shops for his or her own best deal, not the best deal for the customer. This is particularly insidious, as yield-spread premiums

[15] Remarks by Federal Reserve Board Chairman Ben S. Bernanke at the Opportunity Finance Network's Annual Conference, Washington, D.C. (November 1, 2006).

generate a financial conflict of interest in a professional whose primary duty should be to his customer, with the result that consumers pay a higher price than that for which they qualify.[16]

And lenders should not be allowed to use their profitable relationships with brokers as a shield to make abusive loans – lenders cannot simply offload the responsibility to place borrowers in loans they can afford. At a minimum lenders must engage in proper due diligence of the brokers they use and the brokered loans themselves.

The establishment of lender liability for broker acts and omissions is a critical step to clamp down on unfair, deceptive and abusive practices. At a minimum, yield spread premiums should be included in the calculation of what is a high cost loan under California's predatory lending law. This was the legislature's original intent of the law, but was subsequently overturned, erroneously and in conflict with the Department of Real Estate's own legal opinion.[17]

IV. Conclusion

Today we are seeing massive disruptions in the financial markets following years of reckless lending on subprime mortgages. This issue has been prominent in the media recently, but the problems are not new. For years, housing analysts and many policymakers have known that most predatory lending occurs in the subprime market, and that subprime loans too often lead to foreclosure rather than sustainable ownership.

The foreclosure crisis has large potential implications for California. Record numbers of borrowers could lose their homes. Declining housing prices could reduce the equity, wealth and spending of homeowners throughout the state. Jobs are already down sharply in the mortgage industry which has been centered in Southern California, but could spread to the home

[16] Theoretically, the yield spread is paid, at the consumer's choosing, to lower closing costs. Empirically, that trade-off has not been found. *See, e.g.* Testimony of Howell E. Jackson, Senate Banking Committee Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums" (January 8, 2002), available at http://banking.senate.gov/02_01hrg/010802/jackson.htm#N_1_ ("Homeowners who are short on cash could, theoretically, use yield spread premiums to finance settlement costs. My study, however, offers compelling evidence that yield spread premiums are not being used in this way."); *See also* Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing* 44 Harvard J. on Leg. 123, note 94 and sources cited therein.

[17] This would require amending definitions of "covered loan" and "points and fees" to explicitly include YSPs in the counted costs of the loan. Cal. Fin. Code §§ 4970(b)(2) & (c)(2). Under current law, one way a consumer loan is deemed a covered loan and therefore receives special protections is if the total points and fees payable by the consumer at or before closing for a mortgage or deed of trust exceed 6 percent of the total loan amount. California's definition of points and fees includes "all compensation and fees paid to mortgage brokers in connection with the loan transaction."

A YSP is a bonus paid by a lender to a mortgage broker when a loan is originated at an interest rate higher than the minimum interest rate the lender approved. In Wolski v. Fremont Investment & Loan, 25 Cal. Rptr. 3d 500 (Cal. Ct. App. 2005), a state appellate court held that a YSP should not be included in the definition of points and fees because the lender, not the consumer, pays a YSP, and because the consumer pays excess interest only after loan closing. The Court in *Wolski* did not take notice of the fact that the California Department of Real Estate has issued a legal opinion on the issue, finding that yield spread premiums were originally intended by the legislature to be included in the points and fees calculation.

construction sector. And recent turmoil in global credit markets linked to the subprime lending crisis make the prospect of a housing-led recession a real possibility.

While other states have taken action to stem foreclosures and to raise standards on subprime lending, California has yet to enact new provisions. I hope today's hearing marks a turning point where California will take aggressive action to sustain affordable homeownership and restore investor faith in America's subprime mortgage markets.