California State Senate Banking, Finance & Insurance Committee
Senator Michael J. Machado, Chair
Informational Hearing
Impact of and Reactions to Proposed Regulation Z Revisions
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Sacramento, California

Testimony of Paul Leonard, California Office Director
Center for Responsible Lending

Introduction

First, I wish to thank Chairman Machado for convening today's hearing to discuss the new rules proposed by the Federal Reserve Board, and for inviting the Center for Responsible Lending to testify.

I am Paul Leonard, California Office Director of the Center for Responsible Lending (CRL). CRL is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL works closely with a broad range of civil rights, labor and consumer organizations at both the federal and the state level to provide for safe, sustainable and affordable homeownership.

CRL is an affiliate of Self-Help, which consists of a credit union and a non-profit loan fund. For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans. Self-Help has provided over $5 billion of financing to over 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country, with an annual loan loss rate of under one percent. We are also a responsible subprime lender, making affordable mortgage loans to people with blemished credit to allow them to gain a foothold into the middle class.

I want to make three main points today:

- First, California is the epicenter of the national foreclosure crisis.

- Second, the proposed Federal Reserve Board rules, along with other federal efforts are falling far short and are woefully inadequate to address the root causes of this crisis and to rein in abuses that would prevent another crisis from occurring in the future.

- Third, California needs to take the lead to enact its own strong legislation to address and remedy the market and regulatory failures that have brought about the most significant housing crisis and credit crunch since the Great Depression.

PO Box 3638, Durham NC 27702-3638 • 302 W. Main Street, Durham NC 27701 • Phone 919.313.8500 • Fax 919.313.8595
910 17th Street NW, Suite 500, Washington DC 20006 • Phone 202.349.1850 • Fax 202.289.9009
1330 Broadway, Suite 604, Oakland CA 94612 • Phone 510.379.5000 • Fax 510.893.9300
www.responsiblelending.org

I. **California is Ground Zero in the Subprime Foreclosure Crisis.**

A. **California Pays Steep Price for Record Foreclosures**

Last December, CRL estimated that 2.2 million families nationwide—and nearly 500,000 in California—would lose their homes to foreclosure because of reckless lending practices in the subprime market and voracious investor demand for the resulting loans. Newer estimates are even more grim. Based on more recent data from Merrill Lynch, Moody's Economy.com and the MBA's 3Q 2007 National Delinquency Survey, CRL estimates that over 350,000 California homes will be lost to foreclosure in 2008 and 2009 alone. According to RealtyTrac data, California's 2007 foreclosure rate of 1.9% (or one filing for every 52 households) ranked fourth in the nation, while the number of California foreclosure filings (481,392 on 249,513 properties) ranked first.[1] While this crisis impacts all Californians, the Central Valley and Inland Empire have been most heavily hit.[2] For 2007, six California metro areas made the list of the nation's top 15 metro areas by foreclosure rates, and Stockton, with an astonishing rate of 4.866% – or *1 foreclosure filing for every 21 households* – ranked second in the nation.

Subprime loans have and will continue to represent the largest and far disproportionate share of California's foreclosures. Recent data from the mortgage banking industry shows that while subprime loans represent 15 percent of outstanding mortgages in California, they accounted for a stunning 68 percent of recent foreclosures in the second quarter of 2007.[3] CRL research indicates that subprime lending has actually been a drain on homeownership in California, resulting in a net loss of approximately 175,000 homes between 1998 and 2006.

The costs of the subprime problem extend far beyond the families who lose their homes. As CRL reported in its report, *Subprime Spillover*, millions of other families—who diligently paid their mortgages—will be hurt by declines in property values spurred by nearby foreclosures and a weaker housing market. Based upon new foreclosure estimates, CRL estimates in California, approximately 7.5 million homeowners will lose more than $100 billion in property value, with an average individual property losing more $14,000 in value.[4]

The crisis also is significantly impacting the California housing market, as well as the California economy generally. Industry commentators have predicted home value declines in the California housing market of at least 5-15% over the next 18 months,[5] with Goldman Sachs predicting a total correction of 35-40% over the longer term.[6] As a result of the loss in property values, it is estimated that California will lose approximately $4 billion in property tax and sales tax revenues

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[1] RealtyTrac Press Release, "U.S. Foreclosure Activity Increases 75 Percent in 2007" (Jan. 29, 2008), available at http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=3988&accnt=64847.

[2] RealtyTrac Press Release, **"**Detroit, Stockton, Las Vegas Post Highest 2007 Metro Foreclosure Rates" (Feb. 13, 2008), available at http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=4119&accnt=64847.

[3] Unpublished Banc of America Securities Data. August 1, 2007.

[4] These figures are based upon estimates of subprime defaults as reported by Merrill Lynch (The Market Economist, December 14, 2007) and Moody's Economy.com (http://judiciary.house.gov/media/pdfs/Zandi080129.pdf), as well as foreclosure estimates calculated using outstanding subprime loans reported by the MBA in its 3Q 2007 National Delinquency Survey, and CRL subprime spillover report, available at http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html.

[5] E. Scott Reckard, "CEOs see falling home prices and mounting foreclosures," *Los Angeles Times* (Oct. 29, 2007).

[6] Goldman Sachs, "Americas: Specialty Finance: Mortgage Finance" (Oct. 21, 2007)

in 2008.[7] The downturn in the California economy is evident,[8] with some predicting a recession in 2008.[9] While the rate of subprime foreclosures is alarming today, the worst is still ahead. A large majority of ARM rate resets will occur later this year and throughout 2008, peaking in October 2008.[10]

B. Non-Traditional Mortgages Could Be Next Wave of Foreclosures

Moreover, California and the nation will also be confronting a large pool of nontraditional mortgages, and specifically, "payment option ARMs" ("POARMs") that have significant payment resets. Many POARMs are not captured within the definitions of "subprime" that define the loan by the APR, but are often considered "Alt-A" or "nontraditional" loans. However, POARMs are very complicated products, and, in recent years, have been made too often to borrowers for whom they were highly unsuitable.

POARMs provide borrowers with at least three payment options each month: a fully amortizing payment, an interest only payment, and a minimum payment, which is less than the full amount of interest. In many cases recently, lenders offered a very low teaser rate, often in the 1-2% range, in force for only a few days to a few weeks, to draw borrowers into the loan. The "minimum payment" is tied to the introductory rate. The rate applied to the loan switches to a fully indexed rate typically no later than the date the *first* payment is due, sometimes earlier. The interest rate then changes monthly thereafter. The minimum payments, however, are typically fixed or capped for the first five years. (The payments may adjust annually, but there is a low "payment cap" with each annual adjustment – typically no more than 7.5% higher than the prior year's payment.)

The difference between the minimum payment and the full amount of interest due is added into the principal balance of the loan, so that the balance of the loan grows. This is called "negative amortization." The payment then resets upon one of two triggers. Typically, the scheduled reset occurs after five years. With the minimum monthly payments paid, the loan balance will increase each month, and at reset, the borrower will face repayment of a *larger* loan, at the fully

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[7] Global Insight, "The Mortgage Crisis: Economic And Fiscal Implications For Metro Areas" (Nov. 26, 2007), prepared for the United States Conference of Mayors and the Council for the New American City. Similarly, the Legislative Analyst's Office in California has forecast a $10 billion budget deficit in California for 2008-2009, in significant part due to declining property tax revenues. See Elizabeth Hill, Legislative Analyst, "California's Fiscal Outlook: LAO Projections 2007-08 through 2012-13" (Nov. 2007), available at http://www.lao.ca.gov/2007/fiscal_outlook/fiscal_outlook_07.pdf. *See also* National Conference of State Legislatures Press Release "State Finances are Weakening: A new report by the National Conference of State Legislatures shows increased concern over state revenue performance" (Dec. 10, 2007), available at http://www.ncsl.org/programs/press/2007/pr121007.htm.

[8] *See, e.g., id.*; UCLA Anderson Forecast Press Release, "UCLA Anderson Forecast Reports Plenty of Troubles but No Recession on the Horizon: In California, Sluggish Economy will Continue" (Dec. 6, 2007), available at http://uclaforecast.com/contents/archive/media_12_07_1.asp; Bharat Trehan, Federal Reserve Bank of San Francisco, "Fedviews" (Jan. 10, 2008) ("While we are not predicting a recession, the expected pace of real GDP growth over the next year is not a lot higher than what one might get in a mild recession, say, two quarters of slightly negative growth followed by a bounce back—as typically happens after recessions—to above-trend growth over the last two quarters of the year."), available at http://www.frbsf.org/publications/economics/fedviews/index.html.

[9] *See, e.g.*, Rex Nutting, "Could California be in recession? Rise in unemployment shows downturn, one economist says," *Market Watch* (Nov. 9, 2007), available at http://www.marketwatch.com/news/story/could-california-recession/story.aspx?guid=%7B663B7DEA-A93C-42C3-8180-F7CE099373DC%7D

[10] *Id.*

indexed interest rate, amortizing over a shorter term (25 years instead of the original 30 year term.)

The loan *can* reset earlier, however, if the balance reaches what is known as the "principal cap" of the loan. If the negative amortization causes the principal balance to reach a certain threshold before the scheduled five-year reset, usually 115 to 125 percent of the original balance, the loan recasts and requires the borrower to make a fully amortizing payment on the larger loan balance.

Studies have shown that many of these POARMs were originated with lax underwriting standards and stated income features, leading many borrowers to make the minimum payment and creating unaffordable payments when the loan recasts. (Further, there are indications that many borrowers were misled into believing the teaser rate was in effect for the full five years, instead of a few days or a few months.[11]) Indeed, with distressing frequency, these loans seem to have become classic examples of "asset-based lending," in which repayment depended upon home appreciation to support a refinancing or to pay off the loan upon sale, rather than upon the capacity of the borrower to pay the loan from income and assets (other than the home).

Data from Credit Suisse reveals that there will be a spike in Option ARM resets between 2009 and 2011. California is home to roughly one-half of all Option ARM loans in the nation. A recent Barclays PLC analysis found that $312 billion of Option ARMs will recast in the next several years, including $109 billion in 2010 and $118 billion in 2011. Compounding the problem with exploding ARMS that we all are now quite familiar with, data indicates that some 75% of POARM borrowers are paying the minimum payments, meaning that their payment shock combines the impact of both rate shock and the *rising* loan balance.[12] Monthly payments on POARMs will rise between 60 and 80 percent, with falling home prices increasing the likelihood that the balance of the loan will exceed home values. That, of course, makes it difficult, if not impossible, for the borrower to refinance to an affordable, stable loan, or even to sell the property. Barclays sees POARM recasts as a "significant catalyst in increasing foreclosures and further driving down home prices in the near future."[13]

II. <u>The Proposed Federal Reserve Rules Would Allow Reckless Lending to Continue</u>

Congress enacted the Home Ownership and Equity Protection Act (HOEPA) in 1994 in response to evidence of considerable abuse in the subprime mortgage market, and the disproportionate impact those abuses had on minority homeowners.[14] Recognizing that abuses in the marketplace continually change and evolve, Congress built into HOEPA a mechanism to deal with problems as they develop, without the necessity of further legislation. It assigned to the Federal Reserve Board ("FRB" or "the Board") the duty to monitor the market to examine the "adequacy of existing regulatory and legislative provisions" to protect consumers, particularly low-income consumers,[15] and directed the Board to prohibit unfair or deceptive acts or practices – practices

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[11] *See, e.g.*, *Andrews v. Chevy Chase Bank, FSB*, 240 F.R.D. 612, 615 (E.D. Wis. 2007), *appeal pending*.
[12] *Spotlight's On U.S. Alt-A RMBS Issuers as Preformance Deteriorates Rapidly*, Standard and Poor's December 20, 2007, at http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/4,5,5,1,1148450186824.html
[13] Harry Terris, "Barclays: Option ARM Problems Ahead," *American Banker* at 17 (Feb. 22, 2008).
[14] *See, e.g.*, *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining and Home Equity Lending*, Hearings Before the Senate Committee On Banking, Housing and Urban Affairs, 103d Cong. 1st Sess. (Feb. 3, 17, 24, 1993).
[15] Pub. L. No. 103-325, Title I, § 158.

designed to evade HOEPA – and to prohibit refinancing practices that are abusive or otherwise not in the interest of the borrowers. (15 U.S.C. § 1639 (*l*)(2)).

Cautious about the unintended consequences of "overregulation," both Congress and the Board initially took very limited steps to respond to reckless underwriting and improper use of prepayment penalties that trapped borrowers in unaffordable, harmful loans, problems that were evident even then (mid 1990s) in the market.[16] *Events since that time have demonstrated that the unintended consequences* ***of under-regulation*** *can be of even greater concern and can be catastrophic for consumers and the market.* Central to the current crisis are some of the same problems identified in 1993 and 1994: prepayment penalties that lock people into unaffordable loans, inadequate attention to borrowers' ability to sustain payment on the loans, and mortgage broker abuses.[17] In that time, these problems have grown more pervasive and more extreme, demanding substantial regulatory reform. The Board is uniquely positioned to execute that reform, and to restore confidence in the housing market because it is the one federal agency with the authority to set standards for all home loan originators.

The Center for Responsible Lending actively participated in a number of the Federal Reserve Board's hearings leading up to the issuance of these proposed regulations.[18] Although the proposals include some modest progress, on balance, we are deeply disappointed by the product of all this effort. Notwithstanding the pervasive abuses in the system, the FRB has continued to put industry's arguments about "overregulation" over needed reforms to the system, and has failed to rein in practices that have hurt millions of American families, and will continue to hurt perhaps millions more. The FRB's proposed rules are riddled with loopholes. Rather than eliminating some of the root causes of the subprime foreclosure crisis, which in turn would encourage a truly competitive market for home loans, the FRB's proposal permits many dangerous subprime lending practices to continue, and, in some cases, even gives those practices the FRB stamp of approval.

The evidence is now unequivocal: it is the unregulated market that has led to the irresponsible and abusive lending practices that have run rampant in recent years. The resulting high rate of foreclosures may well bring the country and the State into recession (if we are not already there)—yet the FRB has chosen to issue rules that are limited at best, that leave out many risky loans, or that will be unenforceable. Rather than correcting perverse incentives to engage in reckless lending, the FRB proposed rules are extremely weak in the three most important areas it considered, as discussed in detail below.

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[16] H.R. Conf. Rep. No. 652, 103d Cong. 2d Sess. 147, 160 (1994), S. Rep. No. 103-169, at 25-26, *reprinted in* 1994 U.S.C.C.A.N 1881. Limitations on prepayment penalties applied only in narrow circumstances, such as when loan has very high fees or APR and when the penalty is longer than 5 years, 15 USC § 1639(c), Reg. Z,§ 226.32(d)(6)&(7). A 1998 joint FRB-HUD report to Congress also noted continued reports of loans that "degrade financial stability," by being made without concern about the borrower's repayment ability. *Joint Report to Congress Concerning Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development* at 61-62 (July 1998), available at http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf (hereinafter "*Joint Report*").

[17] The 1998 joint FRB-HUD report noted the continuation of such problems in the market. *Id.* at 51. HUD recommended further limitations on lending without regard to ability to pay, further restrictions on prepayment penalties, and applying such reforms to a broader segment of the market than 1602(aa) loans. *Id.* at 74-75.

[18] In response to the Board's initial request for comments, CRL submitted lengthy comments that are available at www.responsiblelending.org/pdfs/crl-frb-comment-aug-15-2007.pdf. Moreover, CRL intends to submit detailed comments to the Board's current proposed rule in March.

A. Ability to Repay Rules: The Toothless Tiger Cub

The current mortgage crisis has resulted, in large part, from lenders making loans to families without engaging in basic underwriting to ensure that the borrowers can afford them. The FRB acknowledged that loosening underwriting standards played a large role in the rise in delinquencies and foreclosures,[19] acknowledged the harm caused to borrowers by unaffordable loans, and acknowledged that there is no benefit to loans that are unaffordable (at the outset), but, notwithstanding this, the FRB's proposed rule does not set a standard requiring that lenders ensure the affordability of each loan.[20] Instead, the FRB sets a rule that is virtually meaningless and unenforceable. As proposed, the new rule would prohibit a lender only from engaging in a "pattern or practice" of making higher-priced mortgage loans based on the value of consumers' collateral without regard to consumers' repayment ability as of consummation.[21]

In practice, a victim trying to enforce this standard is required to show that the lender made unaffordable loans not only to him or her, but also in a "pattern or practice" to other borrowers—a standard that we know from experience is very difficult to prove even when violations have been flagrant. This is the standard that already applies to the highest-cost loans under HOEPA.[22] The FRB, along with HUD, acknowledged the difficulty of enforcement for this standard in a report to Congress in 1998, when it said: "As a practical matter, because individual consumers cannot easily obtain evidence about other loan transactions, it would be very difficult for them to prove that a creditor has engaged in a 'pattern or practice' of making loans without regard to homeowners' income and repayment ability."[23]

Moreover, the FRB backtracks from the earlier-released *Interagency Guidance on Nontraditional Mortgage Product Risks* by limiting the standard to subprime loans and not extending it to nontraditional loans such as POARMs. (As noted earlier, many POARMs are Alt-A, rather than subprime).[24] In the *Interagency Guidance*, the Agencies expressed concerns with the risky features of and increasing use of nontraditional mortgages,[25] and then offered

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[19] Proposed Rule at 8 ("This loosening was particularly pronounced in the subprime sector, where the frequent combination of several riskier loan attributes – high loan-to-value ratio, payment shock on adjustable-rate mortgages, no verification of borrower income, and no escrow for taxes and insurance – increased the risk of serious delinquency and foreclosure for subprime loans originated in 2005 through early 2007.")

[20] As the Board made clear, "The Board is not proposing to prohibit making an individual loan without regard to repayment ability, either for HOEPA loans or for higher-priced mortgage loans." Proposed Rule at 41. Remarkably, the Board appears to admit that unaffordable loans will continue to be made: "The 50 percent DTI cap [for prepayment penalties], while not a perfect measure of affordability, may tend to reduce the likelihood that an unaffordable loan will have a prepayment penalty, which would hinder a consumer's ability to exit the loan by refinancing the loan or selling the house." Proposed Rule at 55.

[21] Proposed Rule at 40.

[22] *See* 15 U.S.C. § 1639(h); Reg. Z, 12 C.F.R.§ 226.34(a)(4).

[23] *See Joint Report*, note 17, *supra*. The existing "pattern and practice" standard for HOEPA's prohibition on asset-based underwriting has not been able to protect any individual consumer, a defect that led at least one judge to note that corrective amendments were called for. *Newton v. United Co. Fin. Corp.* 24 F. Supp. 2d 444, 455 (E.D. Pa. 1998) (noting that although the company made unaffordable HOEPA loans to plaintiffs, the "pattern and practice" requirement precluded relief.).

[24] The Fed's proposed definition of "subprime" is somewhat different than the commonly used rate spread borrowed from HMDA, proposed §226/35)a, 73 Fed. Reg. 1725 (January 9, 2008). CRL has not completed its analysis of what difference this might make as to the universe of loans to which the new rules would apply.

[25] "While many of these risks exist in other adjustable-rate mortgage products, the Agencies concern is elevated with nontraditional products because of the lack of principal amortization and potential for negative amortization. In

proposed guidance regarding "Loan Terms and Underwriting Standards."[26] After considering industry arguments against the proposed underwriting standards for nontraditional loans, the Agencies concluded as follows:

> The Agencies believe that institutions should maintain qualification standards [for nontraditional loans] that include a credible analysis of a borrower's capacity to repay the full amount of credit that may be extended. That analysis should consider both principal and interest at the fully indexed rate. Using discounted payments in the qualification process limits the ability of borrowers to demonstrate sufficient capacity to repay under the terms of the loan. Therefore, the proposed general guideline of qualifying borrowers at the fully indexed rate, assuming a fully amortizing payment, including potential negative amortization amounts, remains in the final guidance.[27]

Given this earlier consideration and rejection of industry arguments, then, it is unfortunate that the FRB chose to issue rules that are much weaker and less likely to have any significant impact on the market that has been allowed to run wild with little regulation for far too long.[28]

B. <u>Prepayment Penalties Rules: The Exceptions That Swallow The Rule</u>

Prepayment penalties on subprime mortgages trap families in bad loans, penalize them for improving their credit record, and strip their equity.[29] As with the problem of unaffordable loans, the FRB acknowledges the dangers of prepayment penalties:

> … [P]repayment penalty clauses, which are found in a substantial majority of subprime loans, place an added demand on the limited equity or other resources available to many borrowers and make it harder still for them to refinance. Borrowers who cannot refinance will have to make sacrifices to stay in their homes or could lose their homes altogether.[30]

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addition, institutions are increasingly combining these loans with other features that may compound risk." *Interagency Guidance*, 71 Fed. Reg. at 58609.

[26] *Id.* at 58610.

[27] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, National Credit Union Administration, "Interagency Guidance on Nontraditional Mortgage Product Risks," 71 Fed. Reg. 58609, 58611-12 (Oct. 4, 2006).

[28] Although the Guidance is stronger than the proposed FRB rules, it is not along sufficient to provide adequate safeguards to borrowers. As discussed below, strong legislation is needed, as the Guidance sets out very basic direction, and does not provide remedies to individual borrowers harmed by a failure to abide by it.

[29] A prepayment penalty is a steep fee imposed for paying off a mortgage loan early, usually when a homeowner refinances. Typically, a prepayment penalty costs six months' interest on the loan, or approximately 3% of the principal loan amount—a significant amount of equity to lose. A 3% prepayment penalty on a $400,000 loan, would cost a California homeowner $12,000.

[30] Proposed Rule at 9

> The injuries prepayment penalties may cause consumers are particularly concerning because of serious questions as to whether borrowers knowingly accept the risk of such injuries. … The lack of transparency is particularly troubling when originators have incentives to impose prepayment penalty clauses on consumers without giving them a genuine choice. Individual originators may be able to earn larger commissions or yield spread premiums on subprime loans by securing loan agreements with penalties, which increase a lender's certainty of recouping from the consumer its payment to the originator. Originators may seek to impose prepayment penalty clauses on consumers simply to increase their own compensation. This risk appears particularly high in the subprime market, where most loans have had prepayment penalties and borrowers may not have had a realistic opportunity to negotiate for a loan without a penalty.[31]

The explanation for the phenomenal growth in prepayment penalties in the subprime market lies instead in the perverse pricing incentive in the subprime market. In exchange for getting loans with a prepayment penalty, lenders pay brokers more in the form of a higher kickback ("yield-spread premium"). In order to maximize his own compensation, the broker middleman maximizes the cost to the consumer. The result is added consumer costs on both the front- and back-ends of the loan.[32]

Rather than banning this "exit tax" on all subprime loans, however, or even providing *any* real and significant limitations, the FRB simply borrows the existing inadequate prepayment restrictions from HOEPA.[33] It would only limit penalties slightly on adjustable-rate mortgages, and otherwise allows prepayment penalties to remain effective for *five full years*, with no limit on their size.[34] The new rule provides that a mortgage may include a prepayment penalty (otherwise permitted by law) if 1) the term is no longer than five years; 2) it does not apply to a refinance by the creditor or its affiliate; 3) the borrower's DTI is not greater than 50%; and 4) the penalty period ends at least sixty days prior to the first date of any payment adjustment.[35]

This so-called "limitation" on prepayment penalties in subprime loans serves instead as an *authorized extension* of prepayment penalties. In recent years, the vast majority of

[31] Proposed Rule at 54.
[32] Sadly, the evidence indicates that this is yet another area in which minority borrowers end up paying more than white borrowers. *See generally* Debbie Gruenstein Bocian et al., "The Effect of Race and Ethnicity on the Price of Subprime Mortgages" (Center for Responsible Lending May 31, 2006).
[33] 15 U.S.C. § 1639(c)(2); Reg. Z, § 226.32(d)(7). Like the existing HOEPA ability –to-pay test, this provision in HOEPA is difficult to enforce. The DTI requirement arguably is too high to be meaningful, *see infra* note 46, and the absence of documentation – or accurate documentation – makes it difficult to determine whether this precondition has been met.
[34] Although effectively allowing prepayment penalties in most cases, the FRB repeatedly states the reverse, that the new rule would "Prohibit prepayment penalties unless certain conditions are met." Even the rule itself does not attempt this backwards construction, but states that "A mortgage transaction subject to this section may provide for a prepayment penalty otherwise permitted by law [] if: …" Proposed Rule at 128.
[35] Proposed Rule at 128.

prepayment penalties in subprime loans – more than 90% – have had terms of 2-3 years.[36] Through its rulemaking, the FRB has put its stamp of approval on much longer term prepayment penalties that will only to serve to trap more people into subprime loans and cause more widespread losses of home equity.

Nor is it sufficient that the FRB rule would require a "reasonable" 60 day refinance period between the end of the prepayment penalty and the first adjustment, as this affords insufficient opportunity to refinance, could be abused by lenders who extend their teaser period by also extending the prepayment lockout period beyond the current market standard of two years, and precludes the borrower from walking away from an abusive loan whose terms are fully disclosed only at the closing.

The proposed rule does not represent a reasonable balance of consumer protections and industry concerns. First, the fact that it extends, rather than limits, prepayment penalties demonstrates that it is simply not a "balance" at all. Second, contrary to industry claims, careful analysis of the effects of anti-predatory lending laws, including those with limitations on prepayment penalties, show that banning prepayment penalties and other predatory practices does not cause a restriction in access to credit, but instead causes a decrease in targeted abuses, and an increase in competition.[37] In fact, in states that have limited prepayment penalties as part of their approach to curbing predatory lending, interest rates have stayed the same or even been lowered, compared with control states where such protections are absent.[38]

C. <u>Yield-Spread Premium Rules: Providing a Roadmap For Abuse</u>

In the subprime market, prepayment penalties and kickbacks to mortgage brokers ("yield-spread premiums") go together, resulting in added consumer costs on both the front- and back-ends of the mortgage loan.[39] Yield-spread premiums encourage mortgage brokers to steer borrowers to loans with higher interest rates than those for which they qualify, creating powerful broker incentives contrary to borrower interests.

The structural market problems associated with the role and compensation of mortgage brokers are hardly a tangential issue. Brokers play an important role in mortgage lending, and lenders use them to originate *the majority* of the loans they make. Their involvement in subprime and

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[36] CRL calculations of subprime 1st lien subrime mortgages originated 2000-2007, that were included in a proprietary loan-level dataset including millions of securitized subprime loans. Only a miniscule number of subrime loans with prepayment penalties (0.47%) had a term that was other than 12, 24, 36 or 60 months. *Id.*

[37] Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, 2-3, 13-17, Center for Responsible Lending (February 23, 2006).

[38] *Id.* In the eleven states that met the study's criteria of targeted mortgage regulation <u>only</u> for their prepayment penalty protections (*Alaska*, Idaho, *Iowa*, Kansas, *Maine*, *Maryland*, *Michigan*, Missouri, Ohio, Wisconsin, and *Vermont*, with the italicized states scoring highest for the level of restrictions), the volume of subprime loans actually *increased* after the restrictions on prepayment penalties were implemented. *Id.* Other states that restricted prepayment penalties saw *no change* in volume following the implementation of these restrictions. *Id.* at 13, Fig. 3.

[39] A yield spread premium (YSP) is a bonus that lenders pay to brokers for placing a borrower in a loan with a higher interest rate than the rate for which the borrower qualifies. Higher rate loans are more attractive to lenders and secondary market investors. YSPs are paid in 85% to 90% of brokered mortgages.

predatory loans is greater still.[40] According to the Mortgage Bankers Association, mortgage, for 2006, brokers originated 45 percent of all mortgages, and 72 percent of subprime loans.[41]

Again, the FRB acknowledges the dangers associated with YSPs:

> The Board shares concerns, however, that creditor payments to mortgage brokers are not transparent to consumers and are potentially unfair to them. Creditor payments to brokers based on the interest rate give brokers an incentive to provide consumers loans with higher interest rates. … The market often leaves brokers room to act on the incentive should they choose, however, especially as to consumers who are less sophisticated and less likely to shop among either loans or brokers.[42]

Rather than eliminating YSPs, however, FRB's proposed rule provides a roadmap for lenders about how to continue to use them, including ineffective disclosure requirements. The FRB's proposed rule leaves yield-spread premiums intact by simply requiring written disclosure—which unscrupulous brokers and lenders can easily bury among the myriad disclosures and paperwork already required.

D. **Even Where Rules Are Better, They Are Limited By The Failure To Include Non-Traditional Mortgages**

In two areas – 1) verification of income and 2) escrow of taxes and insurance – the proposed FRB rules represent a step forward, but unfortunately, leave a large gap in the regulatory framework by failing to extend the new standards to non-traditional mortgages (interest-only loans and payment option ARMs, approximately half of which, were made in California). The FRB acknowledged in its discussion of the proposed rule the risky nature of such loans, and the fact that many of the problems existing in the subprime market extended to the nontraditional loan market.

> Relaxed underwriting was not limited to the subprime market. According to one estimate, interest-only mortgages (most of them with adjustable rates) and "option ARMs" – which permit borrowers to defer both principal and interest for a time in exchange for higher payments later – rose from 7 percent of total consumer mortgage originations in 2004 to 26 percent in 2006. By one estimate these mortgages reached 78 percent of alt-A originations in 2006. These types of mortgages hold the potential for payment shock and increasingly contained additional layers of risk such as loan amounts near the full appraised value of the home, and partial or no documentation of income. For example,

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[40] *See, e.g.*, Testimony of Andrew Celli, Jr., NY Attorney General's Office (May 24, 2000) (describing 10% broker fees and other abuses by brokers selling loans to Delta Funding before the House Banking Committee), available at http://www.house.gov/banking/52400cel.htm.

[41] *See* MBA "Subprime Originations Survey Yearend 2006," (July 2007) at 2; *See also* MBA Research Data Notes, "Residential Mortgage Origination Channels" (Sept. 2006).

[42] Proposed Rule at 65.

> the share of interest-only mortgages with low or no documentation in alt-A securitized pools increased from around 60 percent in 2003 to nearly 80 percent in 2006. Most of these mortgages have not yet reset so their full implications are not yet apparent. The risks to consumers and to creditors were serious enough, however, to cause the federal banking agencies to issue supervisory guidance, which many state agencies later adopted.[43]

The FRB's failure to include nontraditional mortgages in its proposed rules is curious, then, especially when the federal banking agencies issued supervisory guidance for these loans.

Although limited to subprime loans, the FRB rules on income verification do represent a step forward by addressing the lack of documentation of income that has caused significant payment problems on subprime loans.

Similarly, notwithstanding the troubling limitation to subprime loans, the FRB's proposal to require the escrow of taxes and insurance for subprime loans is a positive step, as it will address the common deceptive lending practice of marketing loans with an artificially low monthly payment by excluding mandatory tax and insurance costs. The provision to allow borrowers to opt out after one year does raise concerns whether this will reduce the effectiveness of the requirement.

III. <u>It's Time to Make California a National Model for Reining in Predatory Lending</u>

As discussed in part above, we believe the proposed FRB rules are inadequate to change the market and regulatory failures that have led to the current mortgage crisis: 1) increasingly loose or nonexistent underwriting standards; 2) misplaced financial incentives that created conflicts between industry profits and borrowers' interests; and 3) lack of accountability of all industry players to borrowers.

With this gap in federal regulation, it is left to the States to effectively respond to this crisis through strong legislation. State-regulated lenders originated 60 percent of California's subprime loans in 2006, making regulation of these entities necessary to return stability to the market.[44]

California, which has historically been a model for the states on public policy ranging from the environment to public health to and holds a global reputation of as a bastion of consumer protection, has lagged in its response to the subprime mortgage crisis even though California—its economy, its neighborhoods and its homeowners—stands to lose the most from this meltdown. Other states, including Ohio, Minnesota, North Carolina and Maine, have already acted swiftly to curtail the abuses in the subprime market that are responsible for our current situation. The California legislature now has a number of important bills before it that, if enacted, would address the root causes of the foreclosure crisis and prevent a similar crisis from occurring in the future. The time has come for California to take a stand and establish strong and enforceable predatory lending legislation to serve as a model for other states.

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[43] Proposed Rule at 9 (footnoted citations omitted).
[44] CRL calculations based on 2006 HMDA data.

We propose that California take immediate action in the following areas, discussed in more detail below:

Strong forward-looking California legislation regulating the activities of state-regulated lenders and brokers is necessary for the well-being and future of California's homeowners, communities and economy. Although California has adopted the federal guidance, codification of strong standards is necessary to provide greater enforcement mechanisms, particularly to allow borrowers who have been harmed to seek full redress, without having to rely on regulators to be "cops on the beat."

A. Return to Common-Sense Lending Guidelines

1. Establish Legislative Ability to Repay Standards

Approving loans without evaluating a borrower's ability to repay is an unfair and deceptive practice that does not benefit borrowers. Through this practice, borrowers are deceived into thinking that they can afford a loan, and then when rates increase after the two- or three-year introductory period, they are faced with the ultimate of injuries: the loss of their home and hard-earned equity.

As discussed above, the FRB proposed rules concerning ability to repay are too limited and difficult to enforce. Similarly, the federal regulatory subprime statement that has been adopted by California sets out very basic guidance only, and does not provide remedies to individual borrowers for the shortcomings of their brokers or lenders.

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. Anti-predatory lending laws in Maine, Minnesota, Ohio and North Carolina provide good models. In addition, this DTI standard should include a rebuttable presumption that a borrower does not have sufficient capacity to repay the loan where the DTI was 45 percent of gross income or more. Without a debt-to-income ratio presumption, lenders can simply increase their debt-to-income ratio lending standards commensurately to underwriting to the fully indexed rate, to a clearly unaffordable level, and then argue that they met the fully indexed standard. Moreover, recent reports support that many of the loans of the past several years were made with exceedingly high DTI ratios and were unaffordable even before any rate adjustment.[45] A reasonable DTI standard is necessary to ensure that originated loans really are affordable, with sufficient residual income left for other basic living expenses.

California should enact strong, broad and enforceable statutory standards, such as those that have been proposed in Assembly Bill 1830.

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[45] *See, e.g.*, Les Christie, "Subprime Loans Defaulting Even Before Resets: It Turns Out That Massive Interest Rate Spikes Aren't The Problem – Many Borrowers Couldn't Afford These Mortgages Even At The Low, Introductory Interest Rates," *CNNMoney.com* (Feb. 20 2008) ("Both 2006 and 2007 saw a large proportion of loans with high debt-to-income ratios (DTI), which indicates the percentage of gross income required to pay debt. In 2007 subprime originations, the DTI hit 42.1 percent, up from 41.1 percent in 2006. Borrowers were simply taking on more debt that they could afford."), available at http://money.cnn.com/2008/02/20/real_estate/loans_failing_pre_resets/?postversion=2008022005

2. 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 a higher interest rate in exchange for not documenting their income, even though their W-2s are readily available, or that their income is overstated. Stated income loans hurt borrowers by creating opportunities for overreaching, and, in fact, have been proven to overstate incomes and payment 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."[46] While these are often referred to as "liar's loans", do not assume that the applicant was the "liar." The increase in stated income loans was too often used to make it easier for the originators and lenders to inflate incomes in order make a loan that otherwise could not have been made, or could only have been made for a smaller amount.[47] Indeed, inflating incomes was one of the misdeeds alleged against the nation's largest subprime lender in 2003-2005.[48]

Fitch Ratings recently noted that "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector…"[49] Even in 2007, 40 percent of subprime loans were "low doc" and "no doc" loans.[50] These 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.

Although the FRB rule would require income verification on subprime loans, it would not require it for nontraditional loans, which have are highly prevalent in California.

California should require lenders to verify and document all sources of income for all subprime *and nontraditional* loans using either tax or payroll records, bank statements or any reasonable alternative or third-party verification, as currently proposed by AB 1830.

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

[47] *See, e.g.*, "Subprime Lenders to Face Increased Legislation," *Inside B&C Lending* at 4 (Feb. 29, 2008) ("Stated income loans are filled out by the broker, not the borrower. That's where fraud occurs.") (quoting Alfred Pollard, General Counsel of Office of Federal Housing Enterprise Oversight).

[48] State regulators and attorneys general investigated Ameriquest, resulting in a $325 million settlement in 2006**.** Fabricating or inflating incomes was among the allegations specified, *see, e.g.*, *State of Iowa v. Ameriquest Mortgage Co.*, EQ CE-53090 (petition filed 3/21/06), Para.16(F). See also Settlement Agreement at ¶¶ IV.M.1-5. (Jan. 23, 2006), available at http://www.ameriquestmultistatesettlement.com/pdfs/SettlementAgreement.pdf.

[49] *See* "Structured Finance: US Subprime RMBS in Structured Finance CDOs," *Fitch Ratings Credit Policy* at 4 (New York, NY Aug. 21, 2006).

[50] "Subprime Guidance Did Little To Diminish ARM Share," *Inside B&C Lending* (Feb. 15, 2008).

3. 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 because borrowers are often forced to refinance their mortgage in order to raise the funds to pay their taxes and insurance, needlessly causing substantial injuries of approximately 8% of the loan amount (3% in upfront points and fees, 2% in third party fees, 3% in prepayment penalties), or $32,000 for a $400,000 loan.

Although the FRB rule would require escrow accounts for subprime loans, it would not require it for nontraditional loans, which have are highly prevalent in California.

California should require the establishment of escrow or impound accounts for property taxes and insurance on all subprime *and nontraditional* loans, as currently proposed by AB 1830.

B. Align Financial Incentives with Borrower Needs

1. Ban Prepayment Penalties on Subprime Loans

The proposed FRB rule woefully underregulates prepayment penalties, 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, and otherwise allowing prepayment penalties to proceed unfettered for up to five years – *longer* than the vast majority of prepayment penalties included in subprime loans since at least 2000.

The abusive and pervasive application of prepayment penalties in the subprime market has been a concern since Congress first turned the spotlight to this market sector in 1993. Prepayment penalties have only become more widespread in the intervening years: today prepayment penalties are imposed on about 70 percent of all subprime loans,[51] compared to about 2% of prime loans.[52]

It has been recognized for at least fourteen years – since Congress enacted HOEPA – that prepayment penalties serves to trap borrowers in disadvantageous, higher cost loans.[53] It has

[51] *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 (Dec. 11, 2006). According to MBA data, there was a 69.2% penetration rate for prepayment penalties on subprime ARMs originated in 2006. *See* 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%.

[52] *See* Berson, *Challenges and Emerging Risks*. 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*. This disparity belies any notion that subprime borrowers freely "choose" prepayment penalties.

[53] In 1994, trying a cautious approach, Congress created complicated and narrow restrictions on prepayment penalties in very high-cost (Section 32) loans. H.R. Conf. Rep. No. 652, 103d Cong., 2d Sess. 147, 160; S. Rep. No.

now become apparent that these penalties increase cost on the front end as well because they are linked to higher rates on loans that pay higher yield-spread premiums to brokers. It is this market-distorting relationship that has made subprime prepayment penalties the "glue" for steering borrowers into higher-cost loans than loans for which they qualify. Further, prepayment penalties reduce the likelihood that subprime borrowers will transition into more affordable prime loans.

Indeed, a market that has often justified its role as a "bridge to prime" should not impose a toll so high as to make the bridge uncrossable. Yet that is what has happened with prepayment penalties in the subprime market. The consumer is trapped, and competitors lose, as many borrowers are unable to refinance with more responsible lenders.[54] They also undercut the benefits of homeownership by stripping equity upon refinance, and have been documented to increase the borrower's vulnerability to foreclosure.

While some lenders claim that homeowners receive a lower interest rate in exchange for prepayment penalties, national CRL research reveals no interest rate benefit from subprime loans with prepayment penalties.[55] To the contrary, subprime purchase loans with prepayment penalties had ***higher*** interest rates than loans without prepayment penalties, and there was no statistical difference between the interest rates on subprime refinance loans with or without prepayment penalties.[56]

***California lags in protecting its residents from abusive prepayment penalties*.** At least twelve states broadly ban prepayment penalties. The most recent trend comes from Minnesota and North Carolina, which ban prepayment penalties from the subprime market; ten states (Maine, Massachusetts, New Jersey, Alabama, Alaska, Indiana, Iowa, New Mexico, Ohio, South Carolina and Vermont) have other broad bans on them. Other states provide significant caps on the penalty amount (*e.g.*, 1% or 2% of loan amount) and/or length (*e.g.*, shorter than 2 years). Currently, California law permits prepayment penalties of six months' interest for up to five years on the vast majority of loans, including subprime loans, and six months' interest for up to three years on even the highest-cost loans.

In line with recent state laws in Minnesota and North Carolina and numerous Congressional proposals, California should ban prepayment penalties for all subprime and high cost loans, as has been proposed in Assembly Bill 1830.

103-169, 25-26. (1994 USCCAN. 1977, 1990-91; 1995 USCCAN 1881, 1909-10.) Limitations on prepayment penalties applied only in narrow circumstances, 15 U.S.C. § 1639(c); Reg. Z, 226.32(d)(6) & (7). That the HOEPA rule was insufficient to curb the problem was evident during a joint HUD-FRB review of the market in 1998. In that report, HUD recommended further restrictions on prepayment penalties, and applying reforms to a broader segment of the market. Joint Report to Congress Consumer Reform to the Truth in Lending Act and the Real Estate Settlement Procedures Act, Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development (July, 1998), at 74-75, *available at* http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

[54] *See, e.g.*, Ruth Simon, "Mortgage Refinancing Gets Tougher: As Adjustable Loans Reset at Higher Rates, Homeowners Find Themselves Stuck Due to Prepayment Penalties, Tighter Credit," *The Wall Street Journal* (Feb. 8, 2007) at D1.

[55] Keith S. Ernst, "Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages" (CRL Jan. 2005), available at http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf.

[56] *Id.*

2. Ban Broker Kickbacks from Lenders for Selling Higher Rate Loans

Additionally, it is important to take a stronger approach than the FRB has proposed for addressing the unfair and deceptive tactics that lenders and 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, however, is complaint-driven and ineffective both in deterring broker malfeasance and in providing remedies to borrowers.

Most borrowers believe that brokers act in the borrower's best interests, and that they work to find borrowers the best loan.[57] YSPs are a destructive feature of the subprime market because they encourage brokers to steer borrowers to loans with higher interest rates than those for which they qualify, giving brokers an incentive to act contrary to the borrower's best interests.[58]

As discussed above, the proposed FRB rule California needs to realign broker incentives to get the best loans for borrowers, not the best commissions for brokers. Although brokers purport to be acting on behalf of borrowers, and have a fiduciary duty to the borrowers they represent under both common law and statutory law, the current system provides incentives directly contrary to that duty.[59] Currently, brokers are driven by yield-spread premiums (YSPs) – the kickback paid to them for originating loans at higher rates than those for which the borrower would qualify. Unfortunately, under the current system, brokers are neither lenders nor friends to borrowers—much to the surprise of many homebuyers.

California should enact Assembly Bills 1830 and 2880, which prohibit kickbacks from lenders to brokers on subprime loans.

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[57] Indeed the FRB has recognized as much: "Moreover, consumers often wrongly believe that brokers agree, or are required, to obtain the best interest rate available. Several commenters in connection with the 2006 hearings suggested that mortgage broker marketing cultivates an image of the broker as a 'trusted advisor' to the consumer. Consumers who have this perception may rely heavily on a broker's advice, and there is some evidence that such reliance is common. In a 2003 survey of older borrowers who had obtained prime or subprime refinancings, seventy percent of respondents with broker-originated refinance loans reported that they had relied 'a lot' on their brokers to find the best mortgage for them." Proposed Rule at 6 (citing Kellie K. Kim-Sung & Sharon Hermanson, *Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans*, Data Digest No. 83 (AARP Public Policy Inst., Washington, D.C.), Jan. 2003, at 3, available at http://www.aarp.org/research/credit-debt/mortgages/experiences_of_older_refinance_mortgage_loan_borro.html). *See also* Ren S. Essene & William Apgar, *Understanding Mortgage Market Behavior: Creating Good Mortgage Options For All Americans*, Harvard Joint Center for Housing Studies at 11 (Apr. 25, 2007) ("Moreover, many consumers erroneously believe that the mortgage decision process is based on a set of standard criteria and that the loan officer's or broker's role is to determine whether the borrower meets these objective criteria to be eligible for a loan.")

[58] *See* "Kickbacks Or Compensation," 12 *Stan. J.L. Bus. & Fin.* 289, 338-50, 353 (Spring 2007). The incentives created by this system are bound to lead to conflicts of interest that cost borrowers. For example, the chairman of the Federal Reserve Board, Ben S. Bernanke, has indicated that lenders' compensation practices may provide financial incentives for those who are selling mortgage products to charge some applicants higher interest rates or to "steer" them to higher-priced loan products. Remarks by Federal Reserve Board Chairman Ben S. Bernanke at the Opportunity Finance Network's Annual Conference, Washington, D.C. (Nov. 1, 2006). *See also* Joint Center for Housing Studies, "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations" at 4-5 (Harvard Univ. Mar. 9, 2004) ("Having no long-term interest in the performance of the loan, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear.").

[59] The California Supreme Court found that mortgage loan brokers had a fiduciary duty to their customers nearly 30 years ago. *Wyatt v. Union Mortgage Co.*, 24 Cal.3d 773 (1979). The fiduciary duty was reinforced when it was codified with respect to transactions involving high cost "covered loans." *See* Cal. Fin. Code § 4979.5.

3. Prohibit Steering

Steering is the predatory lending practice of offering borrowers—particularly African-American and Latino borrowers and those with low to moderate incomes—a higher-cost loan when the borrower could actually qualify for a better rate or better terms.

Recent data illustrate that communities of color continue to pay more for home loans than white borrowers: my organization, the Center for Responsible Lending, found in 2006 that for most types of subprime loans, black and Latino households are 30 percent more likely to be given a subprime loan even after controlling for legitimate risk factors.[60]

While pricing disparities can be the result of a variety of factors, including inconsistent application of objective pricing criteria, targeting of families of color by higher-rate lenders or brokers, and a lack of investment by lower-cost lenders in these communities, lenders and policymakers can take a multi-faceted approach to ensuring that all borrowers, regardless of race, receive loans that are fair and sustainable.

California lawmakers should enact AB 1830 and AB 2880, legislation that prohibits brokers or lenders from steering borrowers to loans with terms that are more costly than those for which the borrower qualifies, and should hold lenders and brokers accountable when they do otherwise.

C. Restore Accountability Throughout the Mortgage System

1. Lender Responsibility

In today's mortgage market, dominated, as noted above, by brokers who have financial motivation to make pricing decisions in their best interests and not necessarily in the interests of borrowers, it is appropriate to hold the lender responsible for all 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 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. 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 abusive lending practices—including broker acts and omissions—is a critical step to clamp down on unfair, deceptive and abusive practices.

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[60] 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 31, 2006. http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf

2. Broker Duties And Accountability

Mortgage brokers are individuals or firms who find customers for lenders and assist with the loan process. Brokers are independent contractors – they provide a way for mortgage lenders to increase their business without incurring the expense involved with employing sales staff directly.

As discussed above, brokers play a key role in today's mortgage market. Brokers often determine whether subprime borrowers receive a fair and helpful loan, or whether they end up with a product that is unsuitable and/or unaffordable. Unfortunately, given the way the current market operates, widespread abuses by mortgage brokers are inevitable.

Buying or refinancing a home is the biggest investment that most families ever make, and particularly in the subprime market, this transaction is often decisive in determining a family's future financial security. The broker has specialized market knowledge that the borrower lacks and relies on. While brokers in California have common-law fiduciary duties to borrowers, the subprime mortgage market, as it is structured today, gives brokers strong financial incentives to sell excessively expensive loans to borrowers. These incentives are significantly strong, and the enforcement mechanisms for breach of the duty sufficiently weak that the nearly 30-year old common law duty has been honored more in the breach than in the observance.

Experts on mortgage financing have long raised concerns about problems inherent in a market dominated by broker originations. For example, the chairman of the Federal Reserve Board, Ben S. Bernanke, has indicated that lenders' compensation practices may provide financial incentives for those who are selling mortgage products to charge some applicants higher interest rates or to "steer" them to higher-priced loan products.[61] A report issued by Harvard University's Joint Center for Housing Studies concurred: "Having no long term interest in the performance of the loan, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear."[62]

In summary: Mortgage brokers, who are responsible for originating over 70 percent of loans in the subprime market, have strong incentives to make abusive loans that harm consumers, and no one is stopping them. In recent years, brokers have flooded the subprime market with unaffordable mortgages, and they have priced these mortgages at their own discretion. Given the way brokers operate today, the odds of successful homeownership are stacked against families who get loans in the subprime market.

To make brokers accountable, California should codify the fiduciary duty for *all home loans* as well as other specific duties of brokers to borrowers, and should enact stronger bonding requirements and a right of private action for injured borrowers to seek remedies, all of which are currently proposed in Assembly Bill 2880.

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

[62] Joint Center for Housing Studies, "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community-Based Organizations" at 4-5 (Harvard Univ. Mar. 9, 2004). Moreover, broker-originated loans "are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors." Id. at 42 (citing Alexander 2003).

3. Investor/Assignee Liability

The secondary market for subprime loans lies at the heart of today's mortgage meltdown. Back in the days when families went to their local savings and loan to get a mortgage and the thrift held that loan among its own investments, the interests of borrowers and lenders were perfectly aligned: if the borrower did not pay the mortgage, the lender did not make money. But the growth of the secondary market upset that core alignment of interests between lender and borrower by creating a system where each actor was compensated early in the loan transaction, often within the first month of the loan, thereby reducing the incentive to worry about how the loan would fare later on.[63]

Independent mortgage brokers originate most subprime loans, and receive their compensation from a lender immediately upon brokering the loan. That lender turns around and sells the loan into the secondary market, where it is bundled together with other mortgages and sliced and diced into securities. These securities are then sold to investors, who retain the right to collect payments and enforce the mortgage terms, including the right to foreclose on the home if the event of a default.

As the subprime market grew, Wall Street wanted more and more of these loans offering higher-risk investments with potential for higher returns. The demand from Wall Street was so intense that it encouraged subprime lenders to abandon reasonable qualifying standards, to forget about standard documentation requirements, and to ignore whether borrowers could actually afford the loan. Lenders created new, dangerous loan products that appeared deceptively affordable to borrowers, and brokers pushed these products to earn high fees. After filing for bankruptcy, the CEO of one mortgage lender explained it this way to *The New York Times*, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?"[64]

Or as Alan Greenspan recently told *Newsweek*, "The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We created something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime-loan market would have been very significantly less than it is in size."[65] Wall Street rating agencies also turned a blind eye to the increasingly high volume of poorly underwritten, extremely dangerous loans included in mortgage investments. Paid by the securitizers to rate the tranches, the agencies overlooked loans that any experienced underwriter would have known were headed for foreclosure, giving an AAA rating to the majority of the tranches created.[66]

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[63] Chairman Bernanke makes this point in a recent presentation: "Housing, Housing Finance, and Monetary Policy, remarks by Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System at the Federal Reserve Bank of Kansas City's Economic Symposium – Jackson Hole, Wyoming (August 31, 2007), pp. 16 – 17.

[64] Vikas Bajaj and Christine Haughney, *Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages*," New York Times (Fri. Jan. 26, 2007) C1, C4.

[65] "The Oracle Reveals All," *Newsweek* at 32, 33 (Sept. 24, 2007).

[66] *See, e.g.*, Allan Sloan, "An Unsavory Slice of Subprime," *Washington Post* (Oct. 16, 2007) ("Even though individual loans … looked like financial toxic waste," 68% of the issue was rated AAA.)

The result of this buck-passing was the market meltdown of 2007 and 2008, which now seems to be continuing beyond that. One market watcher recently observed, "Anything securitized in 2007 has got to have the worst collateral performance of any trust I've seen in my life."[67]

The best way to re-align the interests of borrowers and lenders is for California to adopt meaningful liability for subsequent holders of the loan, also known as "assignee" or "holder liability". Since most mortgage loans are sold on the secondary market, it is essential that secondary market liability create incentives for the market to police itself. When assignee liability exists, the borrower is allowed to pursue legal claims against the assignee when the loan transaction involves illegal actions or abusive terms. In the case of the mortgage market, strong assignee liability would mean that when investors purchase high-risk mortgages, with all the corresponding financial benefits, they also accept reasonable liability for when the mortgages prove to be abusive and harm homeowners. If a loan goes into foreclosure as a result of abusive or illegal practices, the borrower would be able to pursue legal action and raise defenses against the foreclosure that might save his or her home.

Like New Jersey and Massachusetts, California should require assignee liability to ensure that the secondary markets help to provide accountability for risky loan originations.

IV. Conclusion

We had hoped the Federal Reserve rules would establish a single strong set of standards governing all players – both federally- and state- regulated – in the mortgage market. Unfortunately, the Federal Reserve's proposed regulations have come up short in a number of crucial areas, making it all the more important for California to fill the void. Although federal bank regulators prevent states from imposing regulations on national banks, California can enact strong legislation to ensure that the state-regulated entities that originated up to 60 percent of subprime loans in recent years engage in responsible lending practices and provide safe and responsible lending products to Californians. Strong action in California will send a signal to Congress that strong changes in federal law are needed.

[67] Shannon D. Harrington and Mark Pittman, "Subprime Delinquencies Accelerating, Moody's Says," (Oct. 5, 2007), available at http://www.bloomberg.com/apps/news?pid=email_en&refer=home&sid=a8Mzhz09jHP8.