

**HR 1728: Mortgage Reform and Anti-Predatory Lending Act**  
**House Financial Services Committee**  
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on behalf of the

**AFL-CIO**

**Communications Workers of America**  
**Consumer Action**

Low-income clients of the **National Consumer Law Center**  
**National Association of Consumer Advocates**  
**National Fair Housing Alliance**  
**Public Citizen**  
**U.S. Public Interest Research Group**  
**Woodstock Institute**

and the following state and local legal services and public interest organizations:

**Center for California Homeowner Association Law**  
of Oakland, California

**Public Counsel** of Los Angeles, California

**Connecticut Fair Housing Center** of Hartford,  
Connecticut

**Jacksonville Area Legal Aid, Inc.** of Jacksonville,  
Florida

**Housing Action Illinois** of Chicago, Illinois

**Civil Justice, Inc.** of Baltimore, Maryland

**Massachusetts Law Reform Institute** of Boston,  
Massachusetts

**WilmerHale Legal Services Center of Harvard Law**  
School of Jamaica Plain, Massachusetts

**Capitol Services/Michigan Advocacy Project** of  
Lansing, Michigan

**Mid Minnesota Legal Assistance** of Minneapolis,  
Minnesota

**Beyond Housing** of St. Louis, Missouri

**Gateway Legal Services, Inc.** of St. Louis, Missouri

**Metropolitan St. Louis Equal Housing Opportunity**  
Council of Saint Louis, Missouri

**Legal Services of New Jersey** of Edison, New Jersey

**Better Neighborhoods, Inc. (BNI)** of Schenectady,  
New York

**Capital District Women's Bar Association Legal**  
**Project, Inc./The Legal Project** of Albany, New York

**Empire Justice Center** of Rochester, New York

**Fair Housing Council of Central New York, Inc.**  
Syracuse, New York

**MFY Legal Services, Inc./Foreclosure Prevention**  
**Project** of New York, New York

**Neighborhood Economic Development Advocacy**  
**Project (NEDAP)** of New York, New York

**The Legal Aid Society in the City of NY/Law**  
**Reform Unit** of New York, New York

**Western New York Law Center** of Buffalo, New York  
**Financial Protection Law Center** of Wilmington,  
North Carolina

**Legal Services of Southern Piedmont** of  
Charlotte, North Carolina

**North Carolina Justice Center** of Raleigh, North  
Carolina

**Advocates for Basic Legal Equality** of Dayton, Ohio –  
on behalf of Edgemont Neighborhood Coalition

**Northeast Ohio Legal Services** of Youngstown, Ohio

**ACTION Housing, Inc.** of Pittsburgh, Pennsylvania

**Greater Philadelphia Urban Affairs**

**Coalition/Campaign for Working Families** of  
Philadelphia, PA

**Community Action2 Committee of the Lehigh Valley**  
of Bethlehem, Pennsylvania

**Community Legal Services** of Philadelphia,  
Pennsylvania

**Consumer Credit Counseling Service of Delaware**  
**Valley** of Philadelphia, Pennsylvania

**Philadelphia Unemployment Project** of Philadelphia,  
Pennsylvania

**Philadelphia VIP** of Philadelphia, Pennsylvania

**South Carolina Appleseed Legal Justice Center** of  
Columbia, South Carolina

**Virginia Poverty Law Center** of Richmond, Virginia

**Vermont Legal Aid, Inc.** of Montpelier, VT

**Columbia Legal Services** of Olympia, Washington

**Mountain State Justice, Inc.** of Charleston, West  
Virginia

**Legal Aid Society of Milwaukee, Inc.** of Milwaukee,  
Wisconsin

**Wisconsin Consumers League** of Milwaukee,  
Wisconsin



## HR 1728: Reform of the Residential Mortgage System

Chairman Frank, Ranking Member Bachus, Members of the Committee, I very much appreciate the opportunity you have provided me to testify on HR 1728. I am here today on behalf of the low income clients of the **National Consumer Law Center**,<sup>1</sup> the **National Association of Consumer Advocates**,<sup>2</sup> **AFL-CIO**, the **Communications Workers of America**, **Consumer Action**, the **National Fair Housing Alliance**, **Public Citizen**, **U.S. Public Interest Research Group**, the **Woodstock Institute**, as well as the low-income clients of the **forty legal services** and public interest organizations from across the nation listed on the title page of this testimony (contact information for each of these organizations is provided in Appendix 1).

First, we want to underscore how much we appreciate the continued efforts of Mr. Watt and Mr. Frank, as well as other members of this Committee, to pass legislation designed to stop the abuses in the mortgage market. We have seen how diligently you have been working in these complex trenches to craft a solution to the difficult, delicate and vexing problems that deregulation of mortgage regulations has spawned. We also are very grateful for the proposed funding for legal services work included in this bill. This funding would significantly supplement the work that our advocates around the country already are doing and allow additional attorneys to assist potentially thousands of homeowners to save their homes from foreclosure. We also appreciate the strengthening of the yield spread premium provision.

Titles I and II of H.R. 1728 (the core mortgage reform standards) provide some important and beneficial improvements over those titles in H.R. 3915. The elimination of the irrebuttable presumption and the strengthened definition of “qualified mortgages” entitled to the safe harbor presumption is a crucial change.

However, unhappily, and with tremendous regret, our primary message today is that in the current form, we have to oppose HR 1728. The bill is complex, convoluted and simply will not accomplish its main goal - to fundamentally change the way mortgages are made in this country. More importantly, in its current form, the bill will do affirmative harm:

1. Section 208 of HR 1728 will preempt the state law claims against holders of loans which are currently the primary tools used for saving homes from foreclosure. These claims must remain viable in both defensive and affirmative claims against the holders of the loans to protect homeowners from predatory mortgages.

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<sup>1</sup>The **National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on mortgage and other consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (6th ed. 2007), *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (1st ed. 2005), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to address predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws. This testimony was written by Alys Cohen and Margot Saunders.

<sup>2</sup>The **National Association of Consumer Advocates (NACA)** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

2. Just as state law remedies against holders are preempted, the bill also fails to provide meaningful remedies against these holders for violations of the prohibitions in the bill. The bill would allow rescission against holders *only* for loans in foreclosure, *only* after the holder has had 90 days to cure the violation and failed to do so, and *then only* if the holder is not a securitization vehicle. We do not believe these limited, complex mechanisms would protect homeowners. To provide meaningful relief and to stop predatory lending - especially when replacing viable, valuable state law remedies against these holders - the new rules must be clear and enforceable against all holders of the loans and must provide incentives to encourage compliance. This bill unfortunately lacks both.

If the purpose of this bill is to preserve home ownership, holders of home mortgages must be responsible for the origination violations of this federal law. The bill contemplates a complex set of transactions through which a homeowner could assert rights against a party with whom the homeowner has no pre-existing relationship and the identity of which may be hard to identify, and then relies on presumed actions by various intermediate parties to the transaction to provide relief to a homeowner struggling to make mortgage payments. Speaking on behalf of the public interest lawyers who are litigating these claims, we need to tell you: *the plan proposed in HR 1728 will not work.*

Direct relief must be available both as defensive actions to stop foreclosures, and as affirmative actions to protect those homeowners who - through great difficulty and perseverance - have avoided default but who are making their payments on predatory mortgages.

Below we provide a detailed analysis of how the current version of HR 1728 needs to be changed to accomplish its goal of preventing bad mortgages from being made in the future and to protect homeowners when the new rules are broken. While there have been some improvements in the language between HR 3915 (passed by the House in November, 2007), these improvements, unfortunately, do not mitigate the serious problems still extant in HR 1728.

Moreover, as we articulated in the April 7 letter to the Chairman signed by dozens of national groups regarding this bill, the basic criterion for any proposal for reform of the mortgage system at this point must be whether, if this law had been in place five years ago, the current mortgage crisis would have been avoided. Unfortunately, it appears that this bill will not repair the misalignment of incentives running through the entire mortgage origination and securitization chain. While Titles I and II have been improved since they were first passed in HR 3915, there are still significant problems with them. Moreover, Title III is based on an antiquated mechanism for regulating mortgages – HOEPA – which has proven to be completely inadequate. The result is a bill which will provide benefits for only sector of the economy – for-profit lawyers. This bill is so confusing that, if passed in its current form, there will be extensive litigation just to work through what the various provisions actually mean.

In the balance of this testimony, we will discuss the following subjects:

- I. The Preemption Provision Erases Key State Law Protections
- II. Answers to Questions Regarding the Impact on Predatory Lending of Specific Provisions of Title II
- III. Our Recommendations for Reform: Simple, Clear Rules Applicable to the Entire Mortgage Market

## I. The Preemption Provision Erases Key State Law Protections

The debate about whether preemption of state regulation of mortgage lending is appropriate has been waging for well over a decade. Proponents of preemption always point to the difficulties faced by an industry marketing products throughout the nation complying with the multiplicity of state laws and regulations. They argue that the costs of ensuring compliance with 50 different state laws are ultimately borne by consumers, and that consumers will have access to less expensive credit – and thus more opportunities for home ownership – if compliance costs were reduced by having one national standard.

The key assumption in this argument for preemption of state laws is that the national standard must fulfill the dual goals of a) establishing strong *incentives* for industry players to make fair, affordable and sustainable mortgages, and b) ensuring that homeowners who have been harmed have access to meaningful redress. Unfortunately, as currently framed, HR 1728 does not provide either incentives for compliance or meaningful redress to homeowners who have been harmed. This is one reason why we are so alarmed that passage of this bill would preempt the viable state law remedies currently used for redress.

Section 208 of HR 1728 would preempt many of the primary tools currently used by homeowners to save their homes from predatory loans while minimizing Wall Street's liability for core market abuses fueled by securitization money and the specifications of the secondary market. The state law claims preempted by Section 208<sup>3</sup> are an essential tool for saving homes from foreclosure and must remain available to address the problem loans held by this part of the mortgage industry.

### A. Broad Preemption of Core Claims

Section 208 first preempts claims against holders and assignees for any claims related to ability to repay (subsection (a) of new Section 129B of the Truth in Lending Act) and net tangible

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<sup>3</sup>SEC. 208. EFFECT ON STATE LAWS.

(a) In General- Section 129C(d) of the Truth in Lending Act (as added by section 204) shall supersede any State law or application thereof that provides additional remedies against any assignee, securitizer, or securitization vehicle, and the remedies described in such section shall constitute the sole remedies against any assignee, securitizer, or securitization vehicle, for a violation of subsection (a) or (b) of section 129C of such Act or any other State law the terms of which address the specific subject matter of subsection (a) (determination of ability to repay) or (b) (requirement of a net tangible benefit) of such section 129C.

(b) Rules of Construction- No provision of this section shall be construed as limiting--

(1) the application of any State law against a creditor for a particular residential mortgage loan regardless of whether such creditor also acts as assignee, securitizer, or securitization vehicle for such mortgage; or

(2) availability of remedies based upon fraud, misrepresentation, deceptive acts or practices, false advertising, or civil rights laws--

(A) against any assignee, securitizer, or securitization vehicle for its own conduct relating to the making of a residential mortgage loan to a consumer; or

(B) against any assignee, securitizer, or securitization vehicle in the sale or purchase of residential mortgage loans or securities.

(c) Definition- For purposes of subsection (b)(2), acts or practices are deceptive if--

(1) there is a representation, omission, or practice that misleads or is likely to mislead a consumer;

(2) from the consumer's perspective, the interpretation of the representation, omission, or practice is reasonable under the circumstances; and

(3) the representation, omission or practice is material so that it is likely to affect the consumer's conduct or decision with regard to a product or service.

benefit (subsection (b) of new Section 129B):

SEC. 208. EFFECT ON STATE LAWS.

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This language appears to require that any claim brought against the holder challenging the terms of the loan or the circumstances surrounding the origination of the loan, which might be construed to address “the specific subject matter” of the federal requirement for the originator to ensure an ability to repay and a net tangible benefit, will be preempted because of Section 208. This broad language seeks to preempt any case with facts relating to the borrower’s ability to pay the loan or the borrower’s benefit from the loan, whether or not the claim itself uses such language directly.

In a landmark case, the Massachusetts Attorney General sought and obtained an injunction prohibiting a servicer – Fremont Investment & Loan – from foreclosing on mortgages it is servicing without the permission of the Attorney General based on the unfair nature of unaffordable mortgage loans. The abuses were comprised of “unsatisfactory lending practices” with regard to the origination of adjustable rate mortgages, including: qualifying borrowers based only on the ability to pay the initial pre-reset payments; failure to verify income; substantial prepayment penalties and product features likely to require frequent refinancings. Fremont had voluntarily entered into an agreement for the Attorney General to review foreclosures and then terminated the agreement when objections were raised. The Attorney General sought an injunction based on the unfairness of the loans following termination of the voluntary agreement. The Superior Court allowed the injunction and the Massachusetts Supreme Judicial Court affirmed the injunction.<sup>4</sup>

This ruling – as well as subsequent actions like it against other originators and servicers holding home loans in Massachusetts – has substantially assisted thousands of homeowners in that state from losing their home to foreclosure.<sup>5</sup> The crux of the claims brought by the Massachusetts Attorney General against Fremont was that the loans were *unfair* because they were not affordable and that Fremont should have known that. Because Fremont securitized many of its loans, the loans in question appear to mostly be held by investors. As this case was not brought against the holders of the loans, it might not be affected by the preemption in Section 208. On the other hand, it is questionable whether the agents of the holders – the servicers – would be reachable by state law if the holders themselves were exempt. More importantly, the case typifies the kinds of claims being used daily on an individual basis against holders of mortgage loans to challenge overreaching mortgage loans.

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<sup>4</sup>Com. v. Fremont Investment & Loan, 452 Mass. 733, 897 N.E.2d 548 at 556 (Mass.,2008).

<sup>5</sup>Over a three year period, Fremont originated over 14,000 mortgages for owner-occupiers in Massachusetts alone; 3,000 were outstanding at the time the injunction was sought, and 2,500 were serviced by Fremont.

There are many, many cases brought all over the nation against holders of loans under claims of unfairness, unconscionability, or other violation of state common or statutory law.<sup>6</sup> We have gathered examples of many of these cases in our report – HR 3915: *Key Home-Saving Measures at Risk: The Threat of H.R. 3915's Preemption Rule.*<sup>7</sup>

The Fremont case in Massachusetts is illustrative of the many cases alleging unfairness and similar claims, which are based on the “specific subject matter” of the federal requirement for the originator to ensure an ability to repay. These claims must be applicable to the holders of the loans,

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<sup>6</sup>See, e.g. *Associates Home Equity Services, Inc. v. Troup*, 778 A.2d 529 (N.J.Super.A.D. 2001) (Assignee of note and mortgage brought foreclosure action, and homeowners filed counterclaim alleging violations of the Consumer Fraud Act (CFA), the Law Against Discrimination (LAD), the Fair Housing Act (FHA), the Civil Rights Act (CRA), and the Truth-In-Lending Act (TILA) by original lender and assignee. Dismissal of unconscionability claim reversed where allegations revealed that the higher interest rates and points charged to the borrowers may not have been warranted (net tangible benefit type of analysis).); *Beneficial Mtg. Co. of Ohio v. Leach*, 2002 WL 926759 (Ohio App. May 9, 2002). (Defense to foreclosure brought by assignee was permitted to continue to trial when borrower alleged unconscionability of loan as a defense.); *Cazares v. Pacific Shore Funding*, 2006 WL 149106, (C.D.Cal. January 3, 2006). (Court finds that in class action alleging excessive fees charged on home mortgages (similar to a “net tangible benefit” analysis), assignees can be liable under California statute prohibiting unfair practices for origination problems with loans, based on both derivative and direct liability.); *Cooper v. First Government Mortg. & Investors Corp.*, 206 F.Supp.2d 33 (D.D.C.2002). (Motion to dismiss denied in case brought by homeowner against mortgage brokers, assignees, and settlement agents challenging excessive fees, and other costs, and onerous and unfair terms of mortgage loan (claims that could be otherwise construed to challenge the “net tangible benefit” of the loan.); *Gilbert v. Security Finance Corp. of Oklahoma, Inc.*, 152 P.3d 165 (Okla.2006). (Borrower's guardian brought action against lenders and non-resident parent corporations and holding companies to recover for fraud, breach of fiduciary duty, and breach of the duty of good faith and fair dealing for consistent overcharging and flipping home equity mortgage (a “net tangible benefit” type analysis). The Oklahoma Supreme Court held that one corporation may be held liable for the acts of another under the theory of alter-ego liability if (1) the separate existence is a design or scheme to perpetuate a fraud, or (2) one corporation is merely an instrumentality or agent of the other. Evidence created jury question on parent corporation's liability for lenders' acts under alter-ego theory.); *Hays v. Bankers Trust Co. of California*, 46 F.Supp.2d 490 (S.D.W.Va.1999). (Borrower sued lenders and assignees of her loans, alleging that overcharges and other problems with the mortgage violated state statutory and common law prohibitions against unconscionability. The federal district court held, *inter alia*, assignee was a “holder” of borrower's note under West Virginia law; civil conspiracy claim applicable to assignee.); *Herrod v. First Republic Mortg. Corp., Inc.* 625 S.E.2d 373 (W.Va.2005). (The home mortgagors alleged that lenders made mortgage loan without regard to their ability to pay the loan, and charged excessive fees (a “net tangible benefit” type claim). The claims against the assignee of the original mortgagee included violations of Consumer Credit and Protection Act, fraud, unfair or deceptive practices, and unconscionability. The West Virginia Supreme Court held that a genuine issue of material fact precluded summary judgment as to assignee's liability under theories of joint venture, agency, or conspiracy.); *In re Maxwell*, 281 B.R. 101 (Bkrcty.D.Mass.2002). Bankruptcy court held as against the holder of the loan that a mortgage refinancing agreement was unconscionable because the sum total of the contract's provisions drives too hard a bargain for court of conscience to assist it (same analysis as a “net tangible benefit” analysis).); *Johnson v. Long Beach Mortgage Loan Trust 2001-4*, 451 F.Supp.2d 16 (D.D.C.2006). (In case in which homeowner alleged that the contract was unconscionable (and other claims) on the basis of excessive fees (a claim similar to a “net tangible benefit analysis), the court allowed claim to proceed against mortgage assignee on the basis of agency.); *M & T Mortgage Corp. v. Miller*, 323 F.Supp.2d 405 (E.D.N.Y.2004). (Purchaser of mortgage settled foreclosure case, and claims were allowed to proceed against originators and others relating to unconscionability and fraud in sale of unaffordable homes to plaintiffs.); *Short v. Wells Fargo Bank Minnesota, NA*, 401 F.Supp. 2d 549 (S.D.W.V. 2005). (When the low-income homeowner went to Delta Funding to borrow \$2000 to \$4000 to pay off some bills, he was provided a loan which refinanced his first mortgage loan and charged over 19% in up-front fees. The federal court held that both the assignee and the servicer of the loan, Wells Fargo Bank and Countrywide, could be found to be parties to a “joint venture” based on the existence of a Pooling and Servicing agreement between them, and thus responsible for both the origination problems (no net tangible benefit) and servicing problems (as well as other claims) brought by the homeowner. The homeowners' claims included unconscionability and breach of contract.); *Williams v. First Government Mortg. and Investors Corp.*, 225 F.3d 738 (D.C. Cir. 2000). (Unconscionability claim allowed against assignee in mortgage based on net tangible benefit and ability to pay type claims.).

<sup>7</sup>[http://www.consumerlaw.org/issues/predatory\\_mortgage/content/HR\\_3915\\_Preemption\\_Analysis.pdf](http://www.consumerlaw.org/issues/predatory_mortgage/content/HR_3915_Preemption_Analysis.pdf)

else the relief – modifying the loans and/or stopping the foreclosures – will not be available. Section 208(a) would preempt the application of these state laws to holders of the loans. The Rule of Construction in subsection (b) – which exempts certain types of state law claims from exemption stated in subsection (a) – does not help because unfairness, as well as other, well used, claims are not in the list.

## **B. Holder Liability at Stake.**

Liability of holders *under current law* provides some accountability because it creates an incentive for buyers of loans to review the loans for compliance with the laws and the standards of the industry governing mortgages. That liability is essential – not only to allow individual homeowners to preserve their homes from foreclosure and preserve their home equity – but perhaps more importantly, to create the incentive for market participants – those infusing liquidity into the system – to police the market. Indeed the failure of assignees to ensure that adequate underwriting took place has been repeatedly criticized by industry experts as one of the reasons for the recent melt-down in the mortgage industry.<sup>8</sup>

Assignees need *more* liability to sufficiently animate these incentives, albeit this potential liability should be capped, so that the risk should be measured and priced for. We have repeatedly proposed that assignee liability for mortgage holders be similar to the liability of assignees of credit sale contracts, as is dictated by the FTC Holder Rule.<sup>9</sup> This cap would limit holder liability to the total of payments on the loan.

Under current state and federal law, a holder can be liable for claims against the originator under any one of a number of theories, largely determined by a combination of factors including state law, the terms of the particular transaction, and the behavior and knowledge of the holder before and during the transfer of the note and mortgage to the holder. The liability of the holder comes in two basic forms: liability stemming from the actions of the mortgage originator (derivative liability) or liability for the assignee's own actions (direct liability).<sup>10</sup> A holder's derivative liability is based simply on the fact that the holder is considered an assignee of the note and mortgage, and may be liable for all claims that could be made against the originator.

An assignee generally can avoid derivative liability if it can show that it is a holder in due course. This is an affirmative defense, which, while often available, is not an automatic status conferred on every holder of every mortgage note, especially in today's mortgage market of

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<sup>8</sup>See, e.g., M. Diane Pendley, Glenn Costello & Mary Kelsch, Fitch Ratings, *The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance* (Nov. 28, 2007), available at [www.fitchratings.com/corporate/reports/report\\_frame.cfm?rpt\\_id=356624](http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=356624) (noting the absence of adequate underwriting contributed significantly to the elevated default rates in 2007); *See* Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, Standard & Poor's, *Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market 12* (Apr. 5, 2007) (increase in early payment defaults within four months of origination, particularly for loans with low documentation and a piggyback loan), available at [www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime\\_040507.pdf](http://www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507.pdf).

<sup>9</sup>16 C.F.R. 433. *See* discussion of the history and the impact of this rule in subsection E, *infra*.

<sup>10</sup>*See generally* National Consumer Law Center, *Cost of Credit* (3rd ed.2005), § 12.12.



adjustable rate loans with well-known defects.<sup>11</sup> In addition, federal claims, such as those made under the Truth in Lending Act, subject holders to derivative liability in some circumstances, notwithstanding their holder in due course status.

Even if the assignee is a holder in due course, and can avoid derivative liability, courts have held assignees liable for origination claims based on the holder's own conduct. For example, state common law and statutory claims may be available to hold the assignee liable based on theories of agency, joint venture, conspiracy, and aiding and abetting.

### **C. Preserved Claims Leave Out Key Protections**

Subsection 208(b)(1) appears to specify that holders will be continue to be liable when they also were original creditor. Section 208(b)(2)(A) appears to preserve holders' liability for their own actions when the claims against them are for fraud, misrepresentation and deception, civil rights laws, and false advertising. Subsection 208(b)(2)(B) appears to extend this preservation of actions against holders for these claims regardless of whether the holders are considered to be directly liable or liable based on their status as an assignee.

There are still many critical state claims that are not preserved, and thus may be preempted because of subsection (a). For example, the following state statutory or common law claims could be preempted against holders when they involve facts challenging the net tangible benefit or ability to pay of a home loan:

- common law unconscionability of contract;
- statutory unconscionability;
- breach of good faith and fair dealing;
- breach of fiduciary duty;
- unfair trade practice;
- breach of contract; and
- state consumer protection statute prohibiting specific activities, such as making loans with no net tangible benefit or without ascertaining the borrower's ability to repay the loan.

### **D. Preempted Claims Save Homes**

Homeowners who have been victimized by predatory mortgages routinely bring actions against the holders of their loans under common law and statutory theories of unfairness, unconscionability, and breach of duty of good faith and fair dealing. These claims generally are used to challenge the overall damaging nature of the loan, sometimes known as a "net tangible benefit" claim, or to challenge the lender's failure to determine the homeowner's ability to pay the loan. Courts regularly allow these claims to go forward, and they are used to save homes around the nation. They are often the main claim used to protect against foreclosure—both because they encapsulate the predominant market abuses of today – unaffordable loans and loans grossly mismatched with the borrower's circumstances – and because, unlike fraud claims, they do not require proof of a series of specific elements. Such challenges are couched in different terms,

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<sup>11</sup>An assignee is a holder in due course only if it can show that a) the mortgage is a negotiable instrument as defined by Article 3 of the Uniform Commercial Code, b) the note was properly endorsed to the holder, c) the holder paid value for the mortgage, and d) the holder purchased it without notice that it is overdue and without notice that there is a defense about any nonpayment. *See* National Consumer Law Center, *Cost of Credit* (3rd ed. 2005), § 10.6.

determined by the rules and requirements of state law and by the facts of the individual cases. They boil down to the same problems: bad loans made with no real analysis of the homeowners' ability to repay or with no material benefit to the borrower.

Claims against the holder that challenge loans based on theories related in any way to these claims appear to be preempted under Section 208, regardless of whether the claims specifically include the words "ability to repay" or "net tangible benefit." The preemption applies whether the claims were made for the assignee's own conduct or for the conduct of the originator for which the assignee is liable as an assignee of the loan.

This preemption of essential claims against assignees would eradicate the ability of homeowners to use legal claims as leverage to stop foreclosures, to void bad loans, or even to modify their loans, when the basis for their claim against the originator is grounded in an analysis similar to "net tangible benefit" or failure to determine the borrower's ability to repay the terms of the loan. Including the holder in the case is critical for the relief needed to address the problem: only the holder has the power to modify or cancel the loan.

Lawyers who represent homeowners in most states—both defensively against foreclosures<sup>12</sup> and affirmatively—routinely use non-fraud consumer claims to challenge the predatory nature of the loans. There are dozens and dozens of examples of these types of cases. Just a few of these examples are gathered together in our report referenced above on the same provision in last year's bill, **HR 3915: *Key Home-Saving Measures at Risk: The Threat of H.R. 3915's Preemption Rule.***<sup>13</sup> Included in this report are numerous reported cases, as well as explanations of other cases, pleadings and orders saving homes from the following states:

- California
- Florida
- Georgia
- Illinois
- Massachusetts
- New Jersey
- New York
- North Carolina
- Ohio
- Pennsylvania
- South Carolina
- Washington
- West Virginia

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<sup>12</sup>In judicial foreclosure states, these claims can be raised as a defense against the foreclosure. In a nonjudicial foreclosure state, it often is necessary to file bankruptcy to have these claims heard, because to stop a foreclosure in a non-judicial foreclosure state requires the filing of an independent, affirmative action, and the issuance of an injunction. In many of these states the bond requirements are prohibitively expensive, so that the only way to stop a foreclosure is to file a bankruptcy.

<sup>13</sup>[http://www.consumerlaw.org/issues/predatory\\_mortgage/content/HR\\_3915\\_Preemption\\_Analysis.pdf](http://www.consumerlaw.org/issues/predatory_mortgage/content/HR_3915_Preemption_Analysis.pdf)

## **E. History is Instructive: Making Holders of Bad Loans Responsible Does Not Reduce Credit Availability**

All players involved in a bad mortgage loan must be part of the solution, just as they are now part of the problem. Wall Street's investment in subprime lending transformed the industry from a modest player into a significant portion of the market. The securitization process also resulted in product development aimed at secondary market sales, rather than at homeowners. Moreover, homeowners facing default and foreclosure must contend with rules set by the trusts holding pools of securitized loans.<sup>14</sup> Assignee liability is the only mechanism that will align market incentives of the holder with those of the homeowners.

Opponents of assignee liability claim that a series of terrible events will befall the mortgage industry if full assignee liability is applied. This "sky is falling" list includes: a dramatic decrease in the availability of credit, particularly affecting minorities; ruinous effects on small businesses; unfair burden on the secondary market to police loans, as the process is so routinized and involves so many loans at any one time that a careful review of each loan would be nearly impossible and would dramatically increase the cost of credit.

A key perspective in analyzing these concerns is to look at what happened after the Federal Trade Commission passed the Preservation of Consumers Claims and Defenses Rule (commonly referred to as the "Holder Rule") in 1975.<sup>15</sup>

The Holder Rule applies liability for *all claims and defenses that could be brought against the seller* to assignees of loans used to purchase goods and services.<sup>16</sup> The rule reallocates the cost of seller misconduct from the consumer to the creditor,<sup>17</sup> by abrogating the Holder in Due Course doctrine so that a consumer who has been harmed may obtain a remedy.

When the rule was proposed, the automobile dealers and other sellers of goods argued that, if the rule passed, the cost of credit would increase, credit would be more difficult to obtain, retail merchants would be hurt, financial institutions would stop purchasing consumer loans altogether, businesses would suffer, and many would be forced out of business altogether.<sup>18</sup> The finance companies and the banks insisted that they should not bear the responsibility of policing sellers, the credit finance industry would not survive with the additional red tape, many consumers would stop paying on the loans without cause, and the rule would interfere with free competition.<sup>19</sup>

Not one of these nightmare scenarios materialized. There was no reduction in available consumer credit; there were no indications that sellers were hurt in any way; there was no discernable increase in defaults.

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<sup>14</sup> These rules are set out in Pooling and Servicing Agreements.

<sup>15</sup> 16 C.F.R. 433, 40 Fed Reg. 53506 (November 18, 1975).

<sup>16</sup>The transaction must involve a consumer credit contract and the seller must be in the business of selling goods or services to consumers. The assignee's liability is limited to the amounts paid by the consumer.

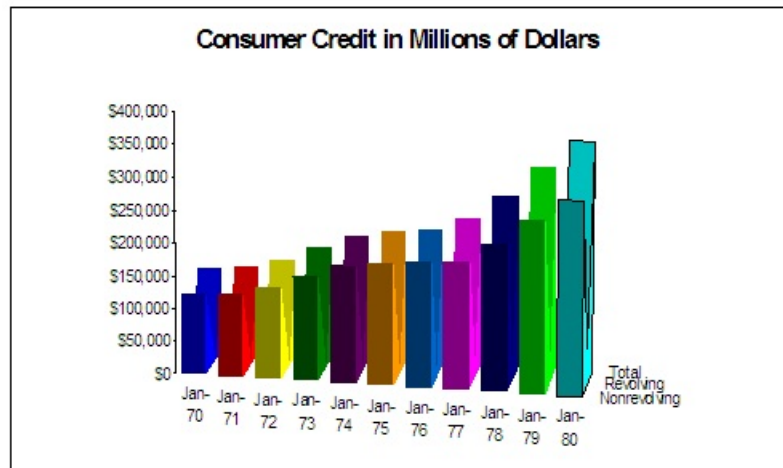
<sup>17</sup>Maberry v. Said, 911 F. Supp. 1393 , 1402 (D. Kan. 1995).

<sup>18</sup> 40 Fed. Reg. 53506 (November 18, 1975) at 53517.

<sup>19</sup>*Id.* at 53518.

The primary argument addressed by the FTC was that the proposed rule would increase the cost of credit or make it very difficult to obtain.<sup>20</sup> Here is a chart showing the level of credit in the United States from 1970 through 1980.

The level of "non-revolving credit" is indicated in the front column and includes auto loans, loans for mobile homes, education, boats, trailers and vacations but excludes all credit card loans. In 1970, total non-revolving credit in the US was approximately \$124 billion; growth continued steadily through the 1970s, with not even a blip in 1975 and 1976 when the FTC rule was announced. By December 1980, total non-revolving credit in the United States was approximately \$297 billion. In the space of ten years, consumer



credit – notwithstanding the announcement and final promulgation of the holder rule<sup>21</sup> halfway through that decade – had more than doubled. The amount of outstanding consumer credit has continued to climb unabated since then: the outstanding amount of non-revolving debt increased over 500% during the seventeen years from January 1980 to December 2007.<sup>22</sup> In the area of auto loans, this FTC rule has not interfered with the securitization of auto credit.<sup>23</sup> Auto ABS volume for

<sup>20</sup> *Id.*

<sup>21</sup> Federal Reserve Statistical Release G.19, 1970 to 1980.

<sup>22</sup>The amount of non-revolving debt (in millions of dollars) was \$295,524.23 in 1980 and grew to \$1,580,039.43 (in millions of dollars) by December 2007. Federal Reserve Statistical Release G.19, 1980 & 2007, available at [http://www.federalreserve.gov/Releases/g19/hist/cc\\_hist\\_nr.html](http://www.federalreserve.gov/Releases/g19/hist/cc_hist_nr.html).

<sup>23</sup>Letter from Vernon H.C. Wright, Chairman, American Securitization Forum, to Financial Accounting Standards Board (May 10, 2004), available at [http://www.americansecuritization.com/uploadedFiles/FAS\\_140\\_Setoff\\_Isolation\\_letter\\_51004.pdf](http://www.americansecuritization.com/uploadedFiles/FAS_140_Setoff_Isolation_letter_51004.pdf). The letter in part describes the FTC Holder Rule and its importance and describes the assessment used in the regular course of business to incorporate such liability into deals. It also states that buyers are willing to assume such risks and purchase such assets.

For decades, a rule of the Federal Trade Commission (the "FTC Rule") has required every consumer credit contract (for instance, retail automobile installment loans) to include a legend to the effect that any purchaser of the contract is subject to all claims and defenses which the debtor could assert against the seller of the goods financed under the contract. This is to assure that consumers are not deprived of important defenses relating to payments owed on defective goods merely because their initial creditor sells the contract.

The Uniform Commercial Code (the "UCC") provides that a buyer of many common types of receivables (for instance, credit card receivables, short term trade receivables and lease receivables) may be subject to all defenses or claims of the debtor against the seller...

Notwithstanding these risks, buyers are willing to purchase these types of assets. For instance, most retail auto installment paper is originated by auto dealers, who assign the paper to a finance company or bank. The finance company or bank may in turn transfer the paper into a securitization. The FTC and UCC rules about setoff are the same for both the initial purchase from the auto dealer and any subsequent transfer into a securitization.

2005 for prime and subprime loans combined exceeded \$75 billion.

## II. Answers to Questions Regarding the Impact on Predatory Lending of Specific Provisions of Title II

### 1. Scope and Potential Effects of New Section 213.

Section 213 of HR 1728 requires the Federal banking agencies to promulgate regulations requiring creditors of mortgage loans which do not meet the qualified mortgage definition to retain a material portion of the credit risk in the mortgages that they originate. The definition of a qualified mortgage, set out in section 102 of the Bill, would be codified in new section 129B of the Truth in Lending Act.

We are not sure of the potential effects of such a requirement. We appreciate capital requirements if they have the effect of imposing market discipline and creating dynamics for the market to police itself. Unfortunately, we are not convinced that this proposal will have the needed salutary effect on the mortgage market, as it appears to us it would not be significantly different from the current practice to require in the sale of most mortgage loans that the originator promise to purchase loans back from the holder if the loans go bad. While the current practice is a contractual promise to re-purchase the entire loan, and the proposed rule would require the originator to retain an ownership interest (at least 5%) in the loan itself, we are not sure that the industry would translate this requirement as imposing more discipline to ensure compliance with state and federal laws.

Clearly, credit retention requirements would significantly increase the capital requirements of the originators, as they could only sell 95% of the loans, rather than 100%. But, if the contractual promise to repurchase 100% of the problem loans back from the holder has not imposed any market discipline on originators, why would requiring an ownership stake in only 5% of the risky loans make a difference?

We understand that it was the retention of the contractual credit risk in the sale of bad loans that has been the primary cause of the bankruptcy or failure of so many predatory creditors – both mortgage companies and financial institutions. Yet, it did not change the originators' behavior when making the loans. The mortgage industry claims that this credit risk retention requirement will either eradicate non-qualified mortgages or cause very high prices. This claim is unsupported by history. Market players have always found ways to adjust to new federal rules and to profit substantially within them.

Moreover, retention of credit risk is clearly something that *can* be priced into the mortgage. The actual cost of that retention of credit risk is obviously a question of some dispute, and not one we are qualified to address. The *fact* that credit risk retention can be priced into the mortgage is an indication that it is likely to be – at best – an imperfect protection against bad mortgages. This is because retention of credit risk does not actually provide any protections to the homeowner/borrower. There are no additional rights of redress to the borrower who has had the misfortune to be provided a high cost loan for which the originator retained credit risk. So there will be no new ways that homeowners will be able to protect themselves against predatory mortgages made by originators who retained credit risk. In addition, homeowners are paying for the increased risk – but it is not clear that originators would be. And it is not clear that the risk retention itself

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Banks and finance companies that buy this paper analyze potential setoff risks as analogous to other ordinary course seller risks that a buyer of any asset takes.

would change the market so as to remove any need for consumer redress. Redress has shown itself to be the primary means for market discipline.

*If non-qualified loans will continue to be made – and because the safe harbor for Qualified Mortgages is narrow, it appears such loans will be made – there must be clear, unambiguous rules applicable to those mortgages, which are enforceable against the holders of those mortgages. There must be strong incentives to the originators of the mortgages to comply with these rules, and equally strong incentives to the buyers of these mortgages to ensure that they are not purchasing loans which do not comply with the rules. There are no such incentives in the HR 1728 as currently written.*

Under the current construct of HR 1728, even with the credit risk retention requirement, there will be few meaningful consequences to an originator who makes a loan in violation of the new requirement to ascertain the borrower's ability to repay the loan. Let us assume a particular originator makes a practice of making loans without properly determining the borrower's ability to repay the loan – as was the case among too many lenders until a few months ago. Presumably this originator would do what so many have done in the past: essentially guard against losses based on the possibility of refinancing the loan when the payments become unaffordable to the borrower. Available equity to fund a refinancing might be found in the difference between the loan amount and either the true value of the house or – as has been done so often in this decade – an inflated value of the house.

What would happen under this bill if a homeowner needed redress for this originator's violations of this new law? Little. First, if the originator still owned the loan, the originator would be given the opportunity to "cure" the violation before any real penalties would be owed. This is per new section 129(d), in section 204 of the bill. So, the originator is caught, a lawsuit is threatened, all of the originator's fees might have to be refunded unless the originator makes the loan comply with the law. Depending on how far off the loan is from being affordable, this could mean a significant or an incremental adjustment in the interest rate.

The originator could now alter the terms of the loan to bring the payments within the affordability requirements. So perhaps the interest rate might be changed from 9% to 8.5% (or the change could be more significant if that were required to make the loan affordable to the homeowner's means at the time of the origination.) But regardless of the change required – whether small or significant – the change is clearly only a cost of doing business. There is no penalty for *not* doing what was required at the outset. The originator does not have to disgorge all of its fees. The originator does not have to pay a penalty for failing to follow the law to begin with. *There is no incentive whatsoever for the originator to comply with the law, because there is no penalty for non-compliance.* In this way, the routine violation of the law is actually economically smart if it is profitable, because the only consequence for violating the law is to comply in the very few instances in which there is a threatened law suit.

As there are few real penalties in this bill for originators who violate the law, the primary financial risk to originators and holders is from a loss resulting from the non-payment on the mortgage. But under current practice, the originators are required to buy back 100% of these bad loans, and in the proposal the originators would risk losing only 5% of their investment. How does this new rule change the dynamics of the marketplace to impose market discipline?

Moreover, requiring credit risk retention does not appear to add any protection whatsoever to the homeowner. It does not encourage the making of the legal, sustainable and affordable loans.

*Unfortunately, because of the limited liability of holders and the persistent right to cure without penalty applicable to both originators and holders, credit risk retention likely will make little difference in the market place. Much more needs to be done in order to effectuate real change in the mortgage market.*

Moreover, given the preemption in the bill of existing state laws that are routinely and successfully used to hold accountable both originators and holders of loans which were made without a determination of the ability to repay or without a net tangible benefit – the mortgage industry will find it easier to make bad loans if HR 1728 were to pass than they can under current law.

## **2. Scope and Effects of Standards and Safe Harbor for *Qualified Mortgages*.**

*If* there were adequate liability in the bill for violating the ability to repay standards and the requirement for mortgages to have a net tangible benefit, *then* providing a conditional safe harbor for certain, specific, generally safe mortgages would be a fine idea. Without clear penalties for violating the rules, it matters little what those rules are.

However, *assuming* that the right to cure in this bill is eradicated and holders were to remain liable for violations of the law, the standards and safe harbor for qualified mortgages are a good start. We do think that there should be clear statutory incentives for good mortgage products, as is provided in Section 203, while it is also a necessity to ensure that even these products can be challenged as improperly made.

We applaud the sponsors of HR 1728 both for narrowing the types of mortgage loans that fall within the parameters of a Qualified Mortgage, and for allowing the presumption of compliance to be rebuttable, rather than irrebuttable. These are both important and positive changes to this proposal, as compared to HR 3915.

A Qualified Mortgage should be simple and transparent. A 30 year mortgage with an interest rate within range of the prevailing rate for conforming mortgages is a very good start. However, a Qualified Mortgage should include the following factors:

- Fully amortizing,
- 30 year loan,
- with a *fixed rate*,
- with no lender or broker points or fees,
- and no prepayment penalties.

These loans are relatively simple for most homeowners to understand. They provide few traps for the unwary, and thus are more transparent. If, in fact, the rates that can be charged for them are also limited – as is currently included in the bill – they also would force originators to be much more cautious about the underwriting. If profits from high interest rates are limited, that forces lenders to be more cautious that all loans will be repaid – as the excess profits from the borrowers that pay the high rates will not be available to cover the losses caused by those borrowers who cannot afford the payments.

We also applaud the change from HR 3915 relating to the presumption of compliance – from irrebuttable to rebuttable. There must always be a way to challenge the legality of a loan. Without that, there will always be some scoundrels in the marketplace who will find the loopholes in the law to take advantage. The latest scams on loan modifications make that clear.

As we explain in Section III of this testimony, we believe that a Qualified Mortgage which includes all of these criteria should be required to be offered to all homeowners applying for a home loan. If the homeowner has credit challenges, the interest rate on the loan can be higher, but all other required components should be included. In this way, every homeowner applying for a home loan would always have the opportunity to obtain a transparent, understandable and safe loan. Requiring the *offer* of the Qualified Mortgage would not preclude the offer of other, more exotic mortgages – but the costs and risks of these other products would be contrasted to the Qualified Mortgage based on uniform method of comparison. Moreover, homeowners should be required to affirmatively opt-out of the Qualified Mortgage, as some have suggested.<sup>24</sup>

### **3. Scope and Effect of Other Provisions in Section 103.**

**A. Prohibitions on steering.** We applaud the sponsors of the bill for including in the bill prohibitions prohibiting racially discriminatory steering. While an efficient financial market theoretically would provide equally qualified borrowers with equally competitive prices on home loans, both quantitative research and anecdotal evidence show that some borrowers, particularly African-American and Latino families, have been steered into worse or more costly mortgages than those for which they qualify.

However, the current provision to prohibit steering prohibits "abusive or unfair lending practices," but does not explicitly preclude steering consumers to loans more costly than those for which they qualify or prohibit certain types of mischaracterizations of information. We concur in the suggestion made to you by the Center for Responsible Lending to add stronger language, as is included in their testimony today.

**B. Yield Spread Premiums.** Again, we concur with the recommendations of the Center for Responsible Lending. Although Sec. 103 does ban yield spread premiums that vary with the term of the loan, it still permits consumers to finance fees, costs and compensations through a higher interest rate on their loan than that for which they qualify. However, financing compensation or other fees through the rate is very confusing for most consumers. Consumer testing by both HUD and the Federal Reserve Board shows that consumers have a great deal of trouble comparing deals that involve financing some portion of costs/fees through the rate. In the subprime market, many consumers ended up paying some costs and fees through a higher rate while at the same time paying additional costs and fees up front, as well as paying discount points and prepayment penalties that were purportedly in there to buy a lower rate - and the prepayment penalties served to locked them into the higher rate.

We strongly recommend banning the ability to finance points and fees through the rate for any mortgage *unless all* fees and costs are paid through the rate.

**C. Expanding Rulemaking Authority on Predatory Terms to All Banking Agencies.** We do think it is a good idea to make it simpler for more agencies to identify and counter predatory lending. However, it seems overly cumbersome to require all of the banking agencies to have to agree on the rules, and such a requirement is likely to result in rules which are least protective of consumers. We recommend that a single federal agency be assigned the role as the protector of consumers and be provided with the capacity to promulgate appropriate rules and regulations.

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<sup>24</sup>See, Mullainathan, Sendhil; Barr, Michael S.; Shafir, Eldar, *A One-Size-Fits-All Solution*, Publisher: New York Times, December 2007. <http://www.wcfia.harvard.edu/node/2396>.



**D. Revised tenant protections.** We very much appreciate the enhanced protections for tenants against foreclosures. The proposed protections will go a long way toward helping innocent victims of this mortgage crisis stay in their homes.

**E. Establishing Framework for Additional Legal Assistance to Consumers Facing Foreclosures.** As is evident from the strong support for this provision from the National Legal Aid and Defender Association (“NLADA”) and many legal services organization across the country, there is a huge unmet need for legal services to deal with foreclosures. All of the state and local signatories to this testimony struggle daily to deal with the scores of homeowners coming to their doors seeking assistance to stop foreclosures. Non-profit attorneys in every state are stretched thin – with huge caseloads – defending foreclosures. Even with the wonderful promise of additional funding in HR 1728, which would go far to help meet this terrible need, these attorneys recognize that additional funding for legal services coupled with preemption of the basic laws they are using to defend those foreclosures is not a win for their clients or their programs. As a result, many of them are reluctantly joining in this testimony to oppose this bill, despite this desperately needed new funding.

### **III. Our Recommendations for Reform – Simple, Clear Rules Applicable to the Entire Mortgage Market**

At a hearing before the Subcommittee on Financial Institutions and Consumer Credit on March 11, 2009, we provided a set of recommendations to reform the mortgage market which we think are simple, inexpensive and would be very successful.<sup>25</sup> Below these recommendations are summarized.

We propose a different orientation to the mortgage regulation conundrum: rather than creating a complex set of rules which are enforceable some of the time by some of the players against some of those involved in the process, create a system which creates *incentives* to accomplish sustainable and secure credit.

We propose to you an approach which carries the following three key characteristics:

1. **Simplicity** – The rules should be fairly easy for most people to understand. Multiple categories of creditors, borrowers, and types of loans result in confusion, without establishing a clear structure designed to facilitate fair, affordable, and safe mortgage lending.
2. **Transparency** – The contracts and obligations of the parties should be simple. The rules governing the transaction should not only be clearly disclosed, but also be easy to understand. The disclosures governing today’s mortgages have become increasingly complex and technical because they are attempting to describe unbelievably complicated transactions. The disclosures must be correct – but if it is too difficult to describe the transaction, perhaps the transaction is too complex to be permitted?
3. **Appropriate Incentives** – The current system rewards originators for making bad loans – because the originators are paid regardless of whether the loan is unfair,

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<sup>25</sup>See, [http://www.house.gov/apps/list/hearing/financialsvcs\\_dem/saunders031109.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/saunders031109.pdf).

fraudulent, or unaffordable. Similarly, mortgage servicers are rewarded for servicing practices which do not sustain homeownership or home-equity. Both the origination and the servicing systems should be re-tooled so that the originators, the lenders, the investors and the servicers *all profit only from practices which promote sustainable, affordable and safe home mortgages.*

## Outline of New Mortgage Regulatory Structure

### 1. Realigning Incentives – Pay Originators from Mortgage Payment Stream Only.

Insurance brokers are paid their commissions entirely from the stream of payments made by the consumer for the insurance product. If the consumer can no longer afford the product and the payments stop being made, the broker does not receive payment – so the insurance broker has every incentive to ensure that the consumer is sold a product that is affordable. The insurance company also has an incentive to ensure that the consumer can afford the insurance product: as soon as the commissions are paid, the amount of the premiums that the company receives increases.

The insurance model of compensating brokers should be used for the mortgage industry: require that both originators and lenders receive all of their costs associated with originating, making and servicing the loan from the *payment stream*. A homeowner making payments on the mortgage is the sign of an affordable, sustainable mortgage – the continued affordability of those payments should be incentivized by the mortgage regulatory structure.

Currently, the origination process itself is the major source of profit. In fact, it is the only source of profit for the mortgage broker and a not-insignificant source of profit for the mortgage lender: both parties generally receive substantial up-front fees (almost always paid for from the consumer's home equity) at the origination of the mortgage. The lender, which then generally sells the loan into a security, also receives compensation at that point. Neither party depends on the payment stream to recover either their costs associated with making the loan, or for their profit. The current system encourages loan churning – making new loans to homeowners over and over – because the *making of the loan* is what generates the business and the profits in this market. This is the incentive that needs to be changed.

If instead the originator received a percentage of each payment for the first – say two – years – of the loan, that originator would have a strong business incentive to ensure that the homeowner would both be able to make the first two years' payments, and that the homeowner would *want to* continue making the first two years' payments.

Even if the loan were affordable, if the homeowner refinanced it after the first few months – say to obtain a lower interest rate – the originator would lose that part of the commission left unpaid. To avoid this refinancing, at the time loan was first made, both the originator and the lender would want to ensure that the loan were the best possible loan available at the time for the homeowner.

This proposal would be structurally simple to implement: simply pass a federal law which requires that all compensation to the mortgage broker, the originating lender, and the holder, be recovered entirely through the regularly scheduled payment stream of the loan. Third party fees necessarily incurred to close the loan would still be paid by the consumer at closing.

**2. Making Simple, Fair Mortgages the Default Mortgage – Mandating the Offer of a *Uniform Mortgage*.** Originators should be required to offer every homeowner applicant for a

mortgage loan a Uniform Mortgage product. The Uniform Mortgage would be defined as a fixed rate, fully amortizing 30 year mortgage at a rate set by the lender in response to the perceived credit risk of the borrower, with no prepayment penalties.

Alternatives to the uniform loan can also be provided by the mortgage originator – but the costs, risks and benefits would always have to be compared to the uniform mortgage that would be offered. These comparisons – to be provided contemporaneously with the offer of the alternative product would have to be provided at the same time as the alternatives are offered, and would be provided via a simple format developed by the federal agency – presumably the Federal Reserve Board – charged with developing the details of the new disclosure and transparency regulations.

These two changes – requiring that all profits from the origination process be paid through the payment stream, plus requiring that homeowners always be offered the uniform fixed rate, fully amortizing 30 year mortgage, with no prepayment penalty – would be relatively simple to mandate, simple to implement, simple to comply with, and simple for consumers to understand.

There would essentially be just one variable in the uniform mortgage that would change in response to the homeowner's particular circumstances – the fixed rate applicable for the full term. These changes would make the process of obtaining a mortgage, as well as the mortgage itself, transparent.

**3. Common Sense Rules Should Be Required.** Deregulation of the mortgage origination and servicing process has produced some strikingly absurd situations: lenders making loans without determining the borrowers' ability to make the scheduled mortgage payments, who then find that those homeowners cannot in fact afford the increasing payments; foreclosures on homes when the investors, the communities, as well as the homeowners would benefit from loan modifications instead.

Common sense rules for sustainable long-term home ownership help not only homeowners but also investors. Federal law should require that those making the decisions about the origination and foreclosure of home mortgages must include some basic, common-sense requirements. For example, the following rules should be applicable to all home mortgages made in the future:

- **Mandate that Originators Find that the Homeowners Can Afford All Payments Due on Loan.** Originators must be required to determine that the homeowners' income will be sufficient to afford all of the payments due on the loan. This includes separate components:
  - All scheduled payments due under the terms of the loan, including any potential increases in the interest rate or principal, must be found to be affordable.
  - All other housing debt, as well as monthly contribution requirements for property insurance and taxes, must be included in the sum of housing debt.
  - All income must be verified through independent means, either using wage statements, bank account and deposit records, or tax information.
- **Mortgage Loans Above Value of Home Should be Prohibited.** Originators should be prohibited from making a mortgage loan for more than the home is worth at the time the loan is made. Similarly, the terms of the mortgage loan should not contemplate that the principal of the loan will climb to an amount over the value of the home. In the current marketplace lenders have made hundreds of thousands of

Payment Option Arm Loans (see next section for more discussion about the dangers of these loans) which included basic loan terms contemplating that the principal of the loans would climb above the home's value at origination. This is a recipe for foreclosure – which is exactly what we are seeing. Similarly, inflated appraisals have become commonplace in states which did not experience the steep increases in real estate values – and homeowners and investors are both suffering. To counter these inflated appraisals, originators should be held fully responsible.

- **No Foreclosures Permitted without Modification of Loans.** Federal law should impose one critical requirement before lenders are permitted to foreclose on a primary residence: the servicer must evaluate the homeowner's situation and offer an affordable loan modification where it will produce more income for the investor than a foreclosure. Currently servicers make more money from a foreclosure than a loan modification. Moreover, the income structure for servicer fees encourages them to pad loans with high servicer fees, pushing more homeowners into foreclosure. The servicer fee structure also needs to be changed.

**4. Full Enforcement Should be Incentivized** – While relying on enforcement of the rules through government administrative action or private litigation is not a sufficient means of making the market successful, public and private enforcement are essential back-ups which serve two essential purposes: 1) they ensure compliance with the rules, and 2) they allow the individuals actually harmed by the violations of the rules to use those rules to protect themselves.

All rules should be enforceable by federal regulators and state attorneys general, as well as by private lawyers. Attorneys' fees and costs should be recoverable by prevailing homeowners. Additionally there should be a general prohibition against unfair, unconscionable or deceptive acts and practices applicable to all involved in the loan origination, servicing and holding. Statutory damages, along with actual damages should be awardable for violation of these rules, up to the value of the combination of the amount remaining due on the loan, plus what has been paid.

**5. Full Responsibility** – No one involved in the creation, the funding of, or the enforcement of a mortgage loan which violates the rules should be permitted to profit from a loan made in violation of the established rules. Here, again, the complexity and negative incentives in the current mortgage marketplace have allowed too many entities to make money from activities which support fraudulent practices, faulty underwriting, and anti-homeowner practices. This needs to be changed, so that everyone in the process profits from practices which sustain homeownership and home equity.

**6. No preemption** – In the current mortgage debacle, it has become clear that the state laws protecting consumers are the last bastion of redress for those homeowners who are fortunate enough to find an attorney able to protect them from foreclosure. State laws on fraud, unfair trade practices, unconscionability, foreclosure defenses, good faith and fair dealing, conspiracy, joint venture, as well as other torts and contract defenses, have been the primary way many individual homes have been saved. The rich and textured common law in the states has been particularly useful to the courts as they craft appropriate responses to the new and complex set of problems that have arisen in recent years.

**Appendix**  
Staff and Contact information  
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Signing on to NCLC's Testimony

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