U.S. SENATE BANKING COMMITTEE

"Homeownership Preservation and Protection Act of 2007"
Key Provisions

We are facing a crisis in the mortgage markets on a scale that has not been seen since the Great Depression: over 2 million homeowners face foreclosure at a loss of over $160 billion in hard-earned home equity. The Conference of Mayors recently reported (November 26, 2007) that they expect a decline of $1.2 *trillion* in property values in 2008 because of the crisis. Over one out of every 5 subprime loans is currently delinquent according to First American Loan Performance, an industry research firm. These high default rates have frozen the subprime and jumbo mortgage markets and infected the capital markets to the point where central banks around the world have had to inject liquidity into the system. One fundamental cause of these problems is abusive and predatory subprime mortgage lending. The Homeownership Preservation and Protection Act of 2007 is designed to protect American homeowners, and prevent this disaster from happening again. The legislation will:

- **Realign the interests of the mortgage industry with borrowers** to insure the availability of mortgage capital on fair terms both for the creation and sustainability of homeownership;

- **Establish new lending standards** to ensure that loans are affordable and fair, and **provide for adequate remedies** to make sure the standards are met;

- **Create a transparent set of rules for the mortgage industry** so that capital can safely return to the market without bad lending practices driving out the good.

In discussion of the "Homeownership Preservation and Protection Act of 2007" it is important to keep in mind that only about 10 percent of subprime mortgages in the past several years have been made to first time home buyers; a majority of subprime loans are refinances. In other words, this market has not been primarily about creating a new set of homeowners. While maintaining access to subprime credit on fair terms is very important – and achieving more reliable access to credit is a primary goal of this legislation – what much of the subprime lending market has done over the past several years is to take the homes and home equity of American families and put it at risk unnecessarily.

Title I: High Cost Mortgages

Definition of "High Cost" Mortgage. The legislation tightens the definition of a "high cost mortgage" for which certain consumer protections are triggered. The new definition, which amends the "Home Ownership Equity Protection Act," (HOEPA) is as follows:

- first mortgages with APRs that exceed Treasury securities by eight (8) percentage points (with a range from 6 to 10%);
- second mortgages with APRs that exceed Treasury securities by ten (10) percentage points (with a range of 8 to 12%); or
- mortgages where total points and fees payable by the borrower are five percent (5%) of the total loan amount, or, for smaller loans of less than $20,000, the lesser of eight (8) percentage or $1,000. The bill revises the definition of points and fees to include yield spread premiums and other charges. It allows for up to two bona fide discount points outside of the 5% trigger.

The following key protections are triggered for high cost mortgages:

- No financing of points and fees. The bill prohibits a creditor from directly or indirectly financing any portion of the points, fees or prepayment penalties. These limitations and prohibitions are designed to discourage lenders from "flipping" the mortgage in order to extract additional excessive fees.

- Prohibition on prepayment penalties. The bill prohibits the lender from imposing prepayment penalties for high cost loans.

- Prohibition of Yield Spread Premiums (YSPs). The bill prohibits YSPs for placing a borrower in a high cost loan that is more costly than that for which the borrower qualifies. Mortgage brokers, who have originated about 70 percent of subprime mortgages, receive higher compensation through YSPs for steering borrowers to these higher cost loans. This bill will eliminate the incentive to "upsell" these borrowers.

- Net Tangible Benefit. The originator must determine that a high-cost refinance loan provides a net tangible benefit to the borrower.

- Prohibition on balloon payments. The bill prohibits the use of balloon payments.

- Limitation on single premium credit insurance. The bill would prohibit the upfront payment or financing of credit life, credit disability or credit unemployment insurance on a single premium basis. However, borrowers are free to purchase such insurance with the regular mortgage payment on a periodic basis, provided that it is a separate transaction that can be canceled at any time.

Title II – Subprime and Non-Traditional Mortgages

Definition of "Subprime Mortgage" and "Nontraditional Mortgage": The legislation creates a new designation in the law for subprime and nontraditional mortgages.

- Subprime mortgages. Mortgages that have interest rates that are 3 percentage points higher than Treasury securities of comparable maturities for first mortgages and 5 percentage points for second mortgages. This definition tracks the Federal Reserve Board's definition of subprime lending for the purposes of the Home Mortgage Disclosure Act (HMDA) reporting. In addition, the legislation includes an alternative measure that is designed to prevent capturing too many mortgages when the yield curve is unusually flat.

- Nontraditional mortgages. These are mortgages that allow deferral of the payment of interest or principal. Interest-only and payment-option ARMs are the current examples of nontraditional mortgages we see most often.

Requirements for making subprime or nontraditional mortgages:

- Ability to repay. A mortgage originator must establish that a borrower has the ability to repay the loan based on the fully-indexed rate, assuming full amortization. In making this determination, the originator must consider the borrower's income, credit history, debt-to-income (DTI) ratio, employment status, residual income, and other financial resources.

- Require Escrows for Taxes and Insurance. While nearly all prime mortgages include escrows for taxes and insurance, very few subprime loans include such escrows. The legislation would require these escrows for all subprime and nontraditional loans.

Nearly all prime loans include escrows for taxes and insurance. Yet, few subprime mortgages include these escrows. Currently, unscrupulous mortgage originators entice unsophisticated borrowers into taking out abusive loans with promises of lower monthly payments, in part by comparing their current payments, which often include escrows, with proposed loans that do not include escrows in the monthly payments and, therefore, appear lower. Then, when insurance or tax payments are due, the borrowers, who often do not have the resources to pay the taxes, are forced to seek new loans to cover the required payments, generating a whole new set of fees. Lack of escrows, in other words, becomes a tool for "flipping" borrowers into yet another, high-cost loan.

- Debt-to-Income Ratio. If a borrower's DTI ratio is greater than 45 percent, a mortgage is assumed to be unaffordable unless the originator can show, at a minimum, sufficient residual income to afford the loan.

The ability to repay standard is largely based on guidance published by the federal regulators in late 2006 and early 2007 and applied to the subprime and nontraditional mortgage markets.

<u>The following protections apply to borrowers who take out subprime or nontraditional mortgages</u>:

- <u>No Prepayment Penalties</u>. The legislation will prohibit all prepayment penalties for subprime and nontraditional loans.

Prepayment penalties unfairly trap subprime borrowers in expensive subprime mortgages. These penalties make it cost-prohibitive to refinance into better loans, or strip out equity when the penalty is paid. Studies done by the Center for Responsible Lending (CRL) show that interest rates on subprime loans are no lower for loans with prepayment penalties – the ostensible rationale for these fees – than for loans without these penalties, even after holding credit scores, LTVs, and other factors constant. Moreover, the CRL study shows that the odds of having a loan with a prepayment penalty increases significantly for borrowers who live in minority neighborhoods.

- <u>No Yield-Spread Premiums (YSPs)</u>. The legislation will prohibit YSPs for subprime and nontraditional loans.

YSPs are payments made by lenders to mortgage brokers, usually without the borrower's knowledge. In exchange for the YSP, the lender charges the borrower a higher interest rate than that for which he could have qualified. The industry justifies YSPs as a way for the borrower to pay the broker's fee and other closing costs without paying cash at the closing table. However, numerous studies have shown that YSPs result in higher costs for consumers. For example, a study done by HUD (while Senator Martinez was Secretary) concluded that half ($7.5 billion) of the $15 billion paid in YSPs at the time of this study "is not passed through ... to reduce closing costs." More recent research by HUD indicates that fees tend to rise even as interest rates do – exactly the opposite of what the industry says should happen – and that this effect is more pronounced for minority borrowers. Research sponsored by Freddie Mac also came to the conclusion that borrowers who pay YSPs along with direct fees pay more for loans, all other things being equal.

- <u>Net Tangible Benefit</u>. The originator must determine that a high-cost refinance loan provides a net tangible benefit to the borrower.

<u>Remedies</u>:

- Individual borrowers who get loans in violation of these provisions will be able to rescind (i.e. "unwind") the loans. Alternatively, at the choice of the borrower, the creditor or holder of the loan may cure the loan by making the borrower whole.

- Actual damages.

- Statutory damages up to $5,000 per loan, regardless of the number of violations per loan (up from $2,000 per loan in current law), plus the sum of finance charges and fees.

- Makes mortgage brokers liable for violations of TILA

- **No class actions for assignees** who perform due diligence to ensure they are not buying loans in violation of the law.

- As in current law, creditors are subject to class actions for making loans in violation of the law with damages capped at the *lesser of* 1% of net worth or $5 million (current law caps class damages at the lesser of 1% of net worth or $500,000).

A key goal of the legislation is to realign the interests of the mortgage production system with the interest of the borrower. In recent years, as many observers have noted, the incentives in the system have worked against the interests of borrowers and resulted in larger loans, at higher rates, with weaker underwriting, and without regard to the ability of the borrower to repay the loans. As <u>The Economist</u> *put it:*

> *Mortgages were written for a fee, sold to investment banks for a fee, then packaged and floated for another fee. At each link in the chain, the fees mattered more than the quality of the loans....*

To insure that the quality of the loans does *matter, a reasonable amount of responsibility for making good loans must travel with the mortgage. The legislation allows for individual actions by borrowers who have been given illegal loans to make themselves whole. There will be* no class liability *for assignees who exercise due diligence to avoid funding and buying these loans.*

Moreover, it is crucial that the burden of curing an illegal loan rest not with the victims, such as Dorothy King, the elderly woman who testified before the Senate Committee on Banking, Housing, and Urban Affairs in February, 2007. The subprime borrower is often more vulnerable, less sophisticated, lower income, and less likely to have access to better lenders. For the subprime borrower, or most any borrower, their home is their chief asset. If the borrower faces the loss of her only real asset through a foreclosure, for instance, as a result of a violation of the law, it is simply not fair to put the burden on her to find a party that can make her whole, spending months in the courts while she faces the loss of her home. The sensible and fair thing to do is to allow her to go to the only party that can give her relief – the note holder. The note holder, which is typically a large institutional entity such as a pension fund, insurance company, hedge fund or the like, is in a far better position to recover from another party who may have caused the problem. In the long run, this process will bring more discipline to the mortgage marketplace, the very kind of discipline that has been missing over the past several years.

Title III – All Mortgages

All home loan borrowers get the following rights and protections:

- All mortgage originators – lenders and brokers – owe a duty of good faith and fair dealing to borrowers. The duty of good faith and fair dealing is widespread in state law with regards to the execution of contracts. It would apply that duty to the making of a mortgage contract, which is a new, but reasonable application.

- All mortgage originators have to make reasonable efforts to make an advantageous loan to the borrower, considering that borrowers circumstances. For example, this requirement would prohibit a broker or lender from giving an adjustable rate mortgage with a high likelihood of escalating costs to an elderly person on a fixed income.

- Mortgage brokers owe a fiduciary duty to their customers. The bill designates mortgage brokers as fiduciaries of borrowers. This means that brokers represent the borrower in the transaction.

Today, brokers typically sell their services by telling borrowers that they will do the shopping for the borrowers. Indeed, the National Association of Mortgage Brokers (NAMB) made the claim on their web site (until they were questioned about it at a Senate Banking Committee hearing) that brokers serve as "mentors" to borrowers to help them through the complex process of getting a loan. An industry publication, Inside B & C Lending, described mortgage brokers as being particularly adept at convincing borrowers that they were "trusted advisors" to the borrowers. The bill would simply make the brokers live up to the role they often claim for themselves – that of a fiduciary.

- Prohibit steering. Mortgage originators are prohibited from steering borrowers to more costly loans than that for which the borrower qualifies. This provision is designed to counteract the widespread problem of prime quality borrowers being steered into subprime loans. This provision would require originators to notify borrowers that they qualify for higher quality loans, even if the originator does not offer those prime loans.

Over the past several years, there have been estimates that from 20 to 50 percent of subprime borrowers could have qualified for prime loans. The Wall Street Journal ("Subprime Debacle Traps Even Very Credit-Worthy," December 3, 2007) reported on a study it commissioned that found in 2006 that 61% of subprime loans went to "people with credit scores high enough to often qualify for conventional loans with far better terms." HMDA data repeatedly shows that minorities are given higher cost loans in disproportionate numbers.

- Limitations on Yield-Spread Premiums. Allows YSPs only in the case of no-cost loans. (YSPs for high-cost, subprime, and nontraditional mortgages would be prohibited). Where YSPs are paid, brokers may not receive any other compensation from any other source and prepayment penalties are prohibited.

As discussed above, mortgage brokers argue that YSPs are a way for cash-constrained *borrowers to cover closing costs, including the broker fee. However, independent research has consistently shown that mortgage brokers keep at least half or more of the YSPs for themselves. For example, HUD research showed that no more than half of all YSPs went to offset closing costs. Other research commissioned by Freddie Mac, showed that borrowers who paid a combination of direct fees and YSPs paid significantly more in fees than borrowers who got no-cost loans where a broker's compensation came completely from the YSP. Research also indicates that there is a significant racial component to YSPs. Racial minorities pay even more in fees than similarly situated white borrowers.*

- <u>Limit Low- and No-Documentation Loans</u>. The legislation requires adequate documentation for mortgage loans. However, it gives the Federal Reserve the authority to make exceptions as deemed appropriate, presumably for prime loans.

<u>Remedies</u>:

- Individual borrowers who get loans in violation of these provisions will be able to rescind (i.e. "unwind") the loans. Alternatively, at the choice of the borrower, the creditor or holder of the loan may cure the loan by making the borrower whole.

- Actual damages.

- Statutory damages up to $5,000 per loan, regardless of the number of violations per loan (up from $2,000 per loan in current law).

- Makes mortgage brokers liable under TILA for violations of TILA.

- No class liability for assignees.

<u>Title IV – Good Faith and Fair Dealing In Appraisals</u>

<u>Requirements for Appraisers</u>

- <u>Appraisers owe a duty of good faith and fair dealing to borrowers</u>.

- <u>No lender may encourage or influence an appraiser to "hit" a certain value in connection with making a home loan</u>. In addition, a lender may not seek to influence an appraisers work, nor select an appraiser on the basis of an expectation that he or she will appraise a property at a high enough value to facilitate a home loan.

A crucial cause of the current mortgage meltdown has been inflated appraisals. Many ethical appraisers complain that lenders will only use appraisers who consistently value properties at the levels necessary to allow the loan to close. Appraisers who do not cooperate simply do not get hired. This is particularly detrimental to the homeowner because it leads the homeowner to believe he or she has equity where little or none may exist.

- <u>Appraisers must obtain bonds equal to one percent of the value of the homes appraised</u>.

<u>Remedies available to borrowers</u>

- Lenders must adjust outstanding mortgages where appraisals exceeded true market value by 10 percent or more.

- When an appraisal exceeds market value by 10 percent (plus or minus 2 percent) or more, a borrower has a cause of action against the lender. A consumer who is awarded remedies under this section shall collect from the appraiser's bond.

- Actual and statutory damages up to $5,000.

Title V – Good Faith and Fair Dealing in Home Loan Servicing

Requirements for mortgage servicers:

- Mortgage Servicers owe a duty of good faith and fair dealing to borrowers. James Montgomery, former Chairman of Great Western Financial Corporation, and a former director of Freddie Mac, said recently, "Servicers make money on foreclosure," (American Banker, December 4, 2007). This standard would prevent servicers from unfairly profiting from their servicing responsibilities.

- Prompt crediting of payments. Servicers must credit all payments on the day received. Payments must first be credited to principal and interest due on the note.

Servicers can employ a scheme called "pyramiding," by which they hold a payment until it is late, use a portion of the payment to cover the late fee, thereby causing the remaining payment to be insufficient. When the next month's payment is made, it is insufficient to cover the previous shortfall and the new payment, generating another penalty fee. The legislation will require both prompt posting of payments and crediting of payments to principal and interest before being charged to late fees or other charges.

- All fees must be reasonable and for services actually provided, and only if allowed by the mortgage contract. In addition, an adequate notice and statement is required.

- No force-placing of insurance without clear notice to the borrower.

Currently, some servicers claim that the borrower does not have insurance on the property and "force-places" such insurance on the loan. Sometimes, that insurance is purchased from an affiliate; oftentimes the servicer is given a significant commission for doing so. Many times, as was the case with the Fairbanks Capital case settled by the FTC in 2003, the borrowers already had insurance, but were charged for the additional insurance in any case. As with the pyramiding problems, these extra charges could often result in the borrower being put into default.

- Prior to initiating foreclosure, a servicer must attempt to implement loss mitigation.

Even in the dire circumstances existing in the mortgage market today, and despite the nearly universal calls for action from regulators, government officials, and consumer advocates, mortgage servicers have been extremely slow to offer meaningful alternatives to foreclosure for most borrowers. In fact, according to Moody's, only 1 percent of subprime ARM borrowers have received any loan modifications during the current crisis. Furthermore, a new study shows how servicers use the foreclosure process to make additional fees from the troubled borrowers, even borrowers in bankruptcy. These conclusions are consistent with practices uncovered by the FTC in its 2003 investigation of mortgage servicing practices of Fairbanks Capital, one of the largest subprime mortgage servicers at the time. This provision will insure that adequate loss mitigation is offered to the borrower prior to foreclosure.

- <u>Require servicers to report their loss mitigation activities</u>.

In order to see which servicers are meeting their requirements under this provision, the legislation will require public reporting of loss mitigation activities. The lack of responsiveness in the current crisis indicates how important public accountability is to maximize the number of homes saved.

<u>Remedies</u>

Actual and statutory damages (up to $5,000).

<u>Title VI – Foreclosure Prevention Counseling</u>

- Require that borrowers be notified of availability of foreclosure prevention counseling both at closing and upon default.

- Require servicers, with the consent of the borrower, to forward the borrower's name to a HUD-authorized foreclosure counselor upon default.

It is widely agreed that reluctance by delinquent borrowers to respond to communications from the lender or servicer reduces the effectiveness of loss mitigation. The legislation will help expedite contact with the borrower by having it come from a 3rd party counselor.

- The servicer must reimburse the counselor for its work.

- Once a borrower is working with an approved housing counselor, the servicer may not initiate foreclosure for 45 days to give the parties an opportunity to work out a mutually agreeable solution.

VIII. Give the FDIC and OCC UDAP Rulemaking Authority.

Currently, only the Federal Reserve may issue a regulation establishing standards for determining unfair or deceptive acts or practices (UDAP) for banks. The Office of Thrift Supervision has the authority to do this for thrifts, and has indicated its intention of issuing such a rule. This provision would give other banking regulators the same authority. These regulators have requested this authority, and have indicated that they are willing to act.

Other Provisions

- The Federal Reserve Board will be responsible for writing regulations to implement this Act.
- The Act takes effect 6 months after date of enactment.
- The legislation provides protections for renters in foreclosed homes.
- The legislation authorizes additional appropriations to the FBI to fight mortgage fraud.