Testimony of Minnesota Attorney General Lori Swanson

Regarding Predatory Mortgage Lending
and Use of the Board's Authority Under the
Home Ownership and Equity Protection Act of 1994 (HOEPA)
to Curb Abusive Mortgage Lending

Before the Board of Governors of the Federal Reserve System

June 14, 2007

FEDERAL RESERVE BOARD
MARTIN BUILDING
WASHINGTON, DC 20551

Good morning. My name is Lori Swanson, and I am the Attorney General of the State of Minnesota. I thank the Board of Governors of the Federal Reserve System and Board staff for the opportunity to appear before you today to address the topic of predatory mortgage lending.

I. DEFINING THE PROBLEM: THE STACKED DECK AND LACK OF MARKET DISCIPLINE.

Predatory lending is an important topic to address for both citizens and regulators. In addressing the topic, it is important to understand how and why it occurs.

First, why is it important? A mortgage is the largest single financial transaction in which most American consumers will ever participate. The "American Dream" of home ownership has been the way in which most middle income Americans have built a nest egg -- a nest egg for retirement, to send their kids to college, to pay for healthcare expenses, or to leave behind an inheritance for their loved ones. Predatory mortgage lending has been described as a crisis that threatens to displace more American homeowners than Hurricane Katrina. This makes mortgage abuse something that both citizens and regulators alike should want to tackle—and tackle now.

The U.S. Commerce Department reported earlier this year that the savings rate in this country is below zero--the lowest since 1933. Many of our neighbors are living paycheck-to-paycheck, have no financial cushion to fall back on, and cannot work harder, spend less, or save more. This makes them particularly vulnerable to surprises or abuses in their mortgage transaction, such as exploding interest rates, hidden prepayment penalties, or undisclosed tax and insurance payments.

Second, why has predatory lending occurred? At the outset, it is important to recognize that there is an unlevel playing field between the borrower and lender in a mortgage transaction. A mortgage is the most complex financial transaction in which most consumers will ever participate. Anybody who has attended a mortgage closing understands the blizzard of paperwork filled with "legalese" placed before the borrower to sign. This complexity can create an atmosphere where the deck is stacked against the homeowner, and some untrustworthy brokers and lenders use the stacked deck to their fullest advantage and the borrower's detriment.

Further, markets work best when there is some element of risk. When the risk is substantially eliminated, markets tend to lose their discipline. Years ago, most lenders that wrote mortgage loans held the mortgage on their own books until it was repaid by the borrower. In this type of environment, the lender typically knew their customer and had little incentive to write a loan that was likely to go into default. In other words, the underwriting process weeded out risky loans. Today, mortgage loans are routinely repackaged and resold on the secondary market, rather than being held in the originating lender's portfolio. The growth of the secondary market has led to an explosion of subprime loans, from $34 billion originated in 1994 to $213 billion in 2002. The risk of default on those loans often lands far from the broker or lender that originated the loan. A broker has a financial incentive to place even a bad loan in order to earn a commission. Further, lenders that do not intend to hold the loan in their portfolio have a reduced incentive to ensure that a loan is properly underwritten: by the time the borrower defaults, others are left holding the bag. Contractual provisions such as charge-back clauses have not been sufficient to curb the incentive for wayward brokers or lenders to originate unsuitable loans.

II. THE MINNESOTA EXPERIENCE.

Litigation brought by the State of Minnesota demonstrates the types of the abuses occurring through predatory mortgage lending.

The Minnesota Attorney General's Office was one of the first in the country to file a lawsuit against First Alliance Mortgage Company ("FAMCO") in 1999. The lawsuit against FAMCO alleged, among other things, that the company misled Minnesota borrowers into purchasing "teaser" adjustable rate mortgage loans with exploding interest rates and misled them about high loan fees.

In 2002, the Minnesota Attorney General's Office was one of the lead states in a multi-state investigation of Household Finance Corporation ("Household"). Among other things, the investigation alleged that Household placed borrowers in high-cost loans and then forced borrowers to remain in those loans through costly prepayment penalties that were not adequately disclosed. The investigation resulted in a multi-state settlement in which the company paid $484 million in nationwide restitution to borrowers. The settlement limited prepayment penalties, limited the permissible frequency of loan refinancings, and required that originated loans provide an actual benefit to the borrower.

Most recently, the Minnesota Attorney General's Office was one of the lead states in a multi-state investigation of Ameriquest Mortgage Company ("Ameriquest"), then the nation's largest subprime mortgage lender. Among other things, the investigation alleged that Ameriquest made so-called "stated income" or "low documentation" loans in which Ameriquest representatives fabricated or inflated borrowers' income and/or assets in order to make borrowers eligible for mortgage loans. The investigation also alleged that Ameriquest made deceptive and misleading statements regarding interest rates, discount points, and prepayment penalties. Over 99 percent of Ameriquest's loans in Minnesota between 2000 and 2006 were refinancing loans. These loans were often marketed as "cash out" refinancing in which borrowers used the loan proceeds in part to pay off unsecured credit card or consumer debt. Documents uncovered during the investigation quoted former account executives describing the sales environment as a "boiler room." In one email, an Ameriquest manager told his staff of sales agents: "We are all here to make as much f---ing money as possible. Bottom line. Nothing else matters."

The Ameriquest investigation ultimately resulted in a nationwide settlement providing for injunctive relief and monetary payments of $325 million. Among other things, the injunctive relief required the company to use independent loan closers for all subprime loans, ensure that each loan provides an actual benefit to the borrower, and not fabricate or inflate income or assets or sign any documents on behalf of a borrower.

III. THE BOARD SHOULD USE ITS HOEPA AUTHORITY TO REGULATE ABUSIVE LOANS.

I call on the Board of Governors of the Federal Reserve System to adopt substantive regulations to address the predatory mortgage lending crisis. There are many reasons why it is important to act. Mortgage lending and the housing market in general have a significant impact on the nation's economy. Predatory lending negatively impacts financial institutions and investors who purchase bad loans in the secondary market. Many homeowners are highly leveraged. This means that homeowners have difficulty making their monthly payments when lured through fraud or deception into a mortgage they can ill-afford. As a result, we are now seeing high rates of defaults and foreclosures, and these rates are expected to go higher.

Let me now speak to the issue for today's hearing; namely, whether the Board should use its regulatory authority under Section 129(1)(2) of the Home Ownership and Equity Protection Act of 1994 ("HOEPA") to prohibit unfair or deceptive acts or practices in connection with mortgage loans and practices associated with abusive refinancing. The answer is "yes." I urge the Board to use its authority under HOEPA to address all four main subject areas for today's hearings: "stated income" loans, prepayment penalties, taxes and insurance, and unaffordable loans.

I caution the Board that enhanced disclosures alone are not enough. It is very easy, given the highly complex nature of a mortgage transaction, for a broker or lender who is bent on misleading a borrower to do so, regardless of what is contained in mandated disclosures. I believe there is a need for substantive regulations, not just better disclosures.

(1) "Stated income" or "low documentation"/"no documentation" loans.

The Board requests comment on whether "stated income" or "low documentation"/"no documentation" loans should be prohibited for subprime borrowers. The answer is "yes."

We have seen in my State and around the country serious abuses with "stated income" or "low documentation"/"no documentation" loans. Such loans were originally intended to provide an avenue for a self-employed person without a regular periodic paycheck to qualify for a mortgage loan. In recent years, however, the loans have been expanded to subprime borrowers. These loans have been derided as "liar loans"--because the lender does little or nothing to verify the income or assets as stated on the application, the broker can falsify a person's income in order to qualify the person for a loan. In my State, we have seen brokers falsify applications to claim that octogenarians hauled in cash by making bird houses they didn't make or cleaning houses they didn't clean, that a gardener in his early 20's made $6,000 per month as a "landscape engineer," or that a suburban couple earned money renting out a non-existent apartment in their home.

The purpose of "stated income" mortgage fraud is to make the borrower eligible for a loan that otherwise would not be underwritten. It is not surprising that, once the loan is written based on falsified income or assets, the borrower defaults because he or she cannot afford the monthly payments.

Last year, I formed a Predatory Mortgage Lending Study Group comprised of bankers, consumer advocates, business people, and policymakers to recommend solutions to the problem of predatory lending. The Study Group recommended a prohibition on stated income loans due to the demonstrated abuses with these types of products. The Minnesota Legislature this Spring enacted legislation to require for many brokers and lenders that a borrower's income and financial resources be verified by tax returns, payroll receipts, bank records, or other similarly reliable documents when the lender is relying on the borrower's income and financial resources to establish the borrower's ability to repay the loan; that any criteria relied on by the lender must be verified through reasonably reliable methods; and that a statement by the borrower of the borrower's income and resources is not sufficient to establish the existence of the borrower's income or resources.

I urge the Board to better regulate "stated income" or "low documentation"/"no documentation" loans, which have been misused as a tool to perpetrate fraud through the falsification of the homeowners' income or assets. For those who are self-employed and who cannot easily document their income through a W-2, the lender ought to at least look at historical tax returns to make sure that the mortgage applicant has in the past earned something in the ballpark of the income that is stated on the application. The harm to borrowers and secondary market investors arising out of "low documentation"/"no documentation" loan abuses is very real, and the federal government should crack down on the abuses in connection with these loans.

(2) Borrowers' ability to repay.

The Board requests comment on whether lenders should be required to underwrite loans based on the fully-indexed rate and fully-amortizing payments and whether lenders should be required to provide an estimate of the borrower's tax and insurance obligations. The answer to both questions again is "yes."

Far too many mortgage loans have been sold with little or no regard for the borrower's ability to repay the loan. Loose and undisciplined underwriting, fueled by deregulation, has enabled homeowners to be placed in loans which they can ill afford, either because the amount of taxes and insurance was not disclosed to them, because they cannot afford the monthly payment after the introductory teaser interest rate expires, or because the loan is otherwise too expensive. The abuses that have occurred from the lack of market discipline in the underwriting process warrant new substantive federal regulations.

Legislation enacted in Minnesota this Spring requires certain brokers and lenders to verify the borrower's reasonable ability to pay not just the principal, but also the interest, real estate taxes, homeowners' insurance, assessments, and mortgage insurance premiums. For loans in which the interest rate may vary, the reasonable ability to pay must be determined based on a fully indexed rate and a repayment schedule which achieves full amortization over the life of the loan. The fully indexed rate is the index rate prevailing at the time the loan is originated plus the margin that will apply after the expiration of the introductory interest rate. The loan originator must inform the borrower that an additional amount will be due for taxes and insurance and, where known, disclose to the borrower the amount of the anticipated or actual periodic payments for property taxes and insurance.

Further, the Minnesota Legislature also enacted a duty for mortgage brokers in which the broker is considered to have established an agency relationship with the borrower and must act in the borrower's best interest and in utmost good faith toward the borrower. This provision hopefully will help ensure that brokers and lenders do not make loans without regard to the borrower's ability to repay the loan. Because a mortgage is the single most significant financial instrument entered into by most American consumers, it makes sense that brokers be held to a similar duty of care as a securities or insurance agent.

(3) Prepayment Penalties.

The Board requests comment on whether prepayment penalties should be restricted. The answer is "yes."

We have seen throughout the country homeowners trapped in high cost loans due to exorbitant prepayment penalties. Indeed, some borrowers who were placed in unsuitable mortgage loans have had difficulty refinancing to avoid foreclosure due to the high prepayment penalties they must incur in the event of refinancing.

A law passed by the Minnesota Legislature this Spring prohibits a residential mortgage lender from making a subprime loan that contains a provision requiring or permitting the imposition of a penalty, fee, premium, or other charge in the event the loan is prepaid in whole or part. For prime loans, prepayment penalties are prohibited for any partial prepayment of a loan, for prepayment of a loan upon the sale of the home, for prepayment made more than 42 months after the date of the loan, or where the penalty exceeds the lesser of two percent of the unpaid balance to 60 days interest.

IV. Homeowners Need The Board's Help Now.

Many homeowners are in financial distress in Minnesota and throughout the country. I respectfully urge the Board to adopt meaningful substantive regulations to prevent mortgage lending abuses.

While my State has historically had relatively high levels of home ownership, we now face high levels of mortgage defaults and foreclosures. These foreclosures are occurring not just in our cities, but in our wealthiest suburbs and in rural parts of the state. This is bad for the families and homeowners involved, who end up losing their homes or are trapped in expensive and unsustainable mortgage loans. It is bad for the communities and neighborhoods involved, because it results in the devaluation of surrounding property. And it is bad for our economy, financial institutions, and investors in the secondary market.

The situation will worsen, not improve, as more adjustable rate mortgages have their interest rates reset to amounts requiring higher monthly payments. I understand that the Board has encouraged financial institutions under its supervision to work with borrowers who are having trouble meeting their mortgage obligations to reach effective loan restructurings. I strongly encourage the Board to take whatever action is in its power to require and encourage financial institutions to assist borrowers who are in distress as a result of abusive underwriting so that, where possible, those borrowers may avoid foreclosure. The financial institutions that helped create this problem, either by writing abusive loans or providing the financing that enabled these products to be sold improperly, have a responsibility to work with borrowers to help solve this problem.

Finally, I would like to close with a word about federal preemption. I recognize that, unlike some agencies, the Board has not in the past typically argued in favor of federal preemption of state banking or consumer protection laws, and I applaud the Board for this. I urge the Board to continue to follow this approach and hope other federal policymakers will do so as well as they enter the fray of regulating this industry. This decade, we have far too often seen the U.S. Congress and federal agencies pass laws or promulgate regulations to preempt states' ability to protect their patients, their bank customers, their workers, and their citizens. Such preemption has been particularly troubling when preemption is advanced as a means of essentially deregulating various industries. States should be allowed to do better than the federal government when it comes to standing up for their citizens.

I thank the Board again for the opportunity to appear today. I would be happy to take any questions.

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