Date of Hearing: April 25, 2011

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Mike Eng, Chair
AB 406 (Davis) – As Introduced: February 14, 2011

SUBJECT: Adjustable rate mortgages: balloon payments

SUMMARY: Prohibits the inclusion of a balloon payment in an adjustable rate residential mortgage loan.

EXISTING FEDERAL LAW:

Under the Dodd-Frank Wall Street Reform Consumer Protection Act (*Public Law* 111–203—July 21, 2010) balloon payments are prohibited for high-cost loans, which are defined as loans, generally, that have interest rates at 6.5% above prime. Additionally, Dodd-Frank requires the Federal banking regulators, along with the Director of Housing and Urban Development (HUD), the director of the Federal Housing Administration (FHA) and the Securities and Exchange Commission to draft a definition of "qualified mortgage" that gives due consideration to "prohibiting or restricting the use of balloon payments, negative amortization, prepayment penalties, interest-only payments, and other features that have been demonstrated to exhibit a higher risk of borrower default." Furthermore, under Dodd-Franks "qualified mortgage" definition (still subject of additional regulations), a qualified mortgage cannot include terms that lead to balloon payments. Dodd-Frank offers a very narrow exception for "balloon loans" that may, by regulation, be included under a qualified mortgage if certain underwriting standards are met, and that the balloon loan is retained in the portfolio of a lender that meets certain asset size thresholds.

EXISTING STATE LAW:

Provides, under Business & Professions Code Section 10241.4, for various disclosures concerning balloon payments. Under financial code 4995.2 bans higher priced loans from containing provisions that could lead to negative amortization.

FISCAL EFFECT: Unknown

COMMENTS:

Need for the bill.

According the background supplied by the author's office,

> *Although sub-prime lending has largely vanished, reforms such as the Dodd-Frank Act do not go far enough in eliminating the loan features that have contributed to the foreclosure crisis, and may not curb features such as balloon payments sufficiently to prevent future harm when the state and national economies eventually rebound. The Center for Responsible Lending has targeted balloon payments as one of the key indicators of a predatory lending situation. In addition, federal regulators are being criticized for pre-empting state attempts to rein in predatory lending (see attached April*

> *14, 2011 article from the Los Angeles Times, "Lenders Told to Fix Flaws in Foreclosures." State legislation to ban balloon payments is therefore appropriate at this time.*

Background.

This committee has covered in detail in various forums the scope and scale of the subprime lending crisis that precipitated current economic conditions. Regulators were largely unable to keep up with growing innovations in residential mortgage products that transformed product features, largely reserved for experienced borrowers, into the features to assist first time homebuyers into acquiring their first home. With a mass of risky features, coupled with a lack of prudent underwriting and regulatory standards it is of little surprise that this system of mortgage lending could not continue. One of the first responses by regulators was the Interagency Guidance on Nontraditional Mortgage Product Risks, issued in September 2006, and the Statement on Subprime Lending, issued in June 2007. Additionally, SB 385 (Machado), Chapter 301, Statutes of 2007 required California regulators to comply with the parallel guidance documents developed by the Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators for use by state licensees in complying with the federal guidance documents. This guidance set about prudent underwriting standards for non-traditional loan products, meaning those products that allow deferral of principal and/or interest.

On January 9, 2008 the Federal Reserve Board (Board) published proposed rules that would amend Reg Z, which implements Truth in Lending Act (TILA) and the Home Owner Equity Protection Act (HOEPA). The proposal included new restrictions and requirements for mortgage lending and servicing designed to protect consumers from abusive mortgage product features and deceptive acts. This proposal created a new class of loans for coverage called "higher-priced loans." Additionally, in 2009 the Governor signed AB 260 (Lieu) Chapter 629, Statutes of 2009 which incorporated the definition of the Reg Z "higher-priced" loan definition along with California specific restrictions on these loans.

Changes to loan features and products have not been the only response to the subprime crisis. In 2008 Congress passed the Secure and Fair Enforcement of Mortgage Licensing (SAFE) Act, pursuant to Title V of the provisions of the Housing and Economic Recovery Act of 2008 (HR 3221; Public Law 110-289). The SAFE Act requires mortgage loan originators to register with a national database, undergo background checks, and comply with minimum education and ethical requirements.

Just last year, congress passed and the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act, the largest overhaul of financial regulation of this generation. The Dodd-Frank Act also imposes various changes to the mortgage finance and origination system. In addition, to imposing minimum underwriting standards on all mortgages, it proposed regulations to further corral the securitization and risk-retention rules of various mortgage products. The risk retention provisions are designed to force lenders to retain some risk in non-qualified mortgage loans because lessons from the subprime crisis have demonstrated that greater care and accuracy in mortgage lending occurs when the risk of that transaction cannot be fully passed on to the secondary market. While Dodd-Frank put forth ground breaking (and very complex) mortgage lending standards it also empowers and directs federal regulators, including the new Consumer Protection Bureau to draft further mortgage lending rules.

In summary, between state and federal laws passed in the last four years we now have multiple layers and requirements for non-traditional, higher-costs, higher-priced, qualified, and non-qualified mortgages, as well as, standards for loan originators and a new framework for risk retention and secondary market activity.

Finally, with the subprime crisis came a massive and sudden evaporation of capital for the mortgage markets, other than federal government support. Over the last few years, subprime/non-traditional lending is hardly a blip on the radar, if it exists at all for homeowners. With the combination of changes that have occurred, combined with a lack of real test cases in the market, it is hard to determine the true impact of the changes that have already been made. Committee staff predicts that it may take an additional one to two years to have a true picture of the sum total of residential mortgage regulation. At that time, it may become necessary to revisit state codes for clean-up and general fixes to allow the multiple layers of regulation to actually work in concert.

Questions and Issues:

1) Considering the changes within Dodd-Frank concerning balloon payments, is this change really necessary? Dodd-Frank allows only a very narrow window for the inclusion of balloon payments, and in situations that would not appear to affect middle-class homeowners. Additionally, Dodd-Frank allows future regulations that could ban balloon payments, even under those narrow circumstances.

2) With additional regulations not yet drafted by federal regulators, is it appropriate to add on this layer?

3) What evidence exists that loans since the crisis have included abusive balloon payments? This bill will only apply going forward, not to any existing loans that may have balloon payments.

4) The cornerstone of the federal government's foreclosure prevention strategy is the Home Affordable Modification Program (HAMP). Under HAMP, balloon payments may be used to defer interest rate adjustments to help borrowers stay in their home. Could this ban on balloon payments interfere with HAMP modifications?

5) Within the supporting documents provided to the committee is an LA Times Article, *Lenders Told to Fix Flaws in Foreclosures* (April, 14, 2011) describing ongoing discussions between federal regulators and mortgage loan servicers regarding loan modifications. It includes a sentence, used as justification for this bill via reference, that "The bank regulators have been criticized for failing to stop unsafe lending during the housing boom and for preempting state attempts to rein in predatory lending." Many policy makers, and consumer advocates would agree that federal regulators did not react quickly enough and in some cases failed to address consumer protection issues. However, as demonstrated in the background section of this analysis, congress and the state Legislature have responded in an effort to mitigate any potential future crisis. Furthermore, the lack of response pre-subprime crisis is not an indication of responsiveness post-crisis.

REGISTERED SUPPORT / OPPOSITION:

Support

National Asian American Coalition
The Greenlining Institute
West Angeles Community Development Corporation

Opposition

California Association of Realtors'
California Bankers Association
California Chamber of Commerce
California Credit Union League (CCUL)
California Financial Services Association
California Independent Bankers
California Land Title Association
California Mortgage Association
California Mortgage Bankers Association
Civil Justice Association of California
Securities Industry and Financial Markets Association
United Trust Association

Analysis Prepared by: Mark Farouk / B. & F. / (916) 319-3081