

Assembly Banking and Finance Committee Informational Hearing

Covered and Subprime Loans in California: Are Consumers Getting the Protection They Need?

Background Briefing Paper

Introduction

Homeownership, often described as the "American Dream" can provide security for families, serve as a sound investment and help create wealth that can be passed on to future generations.

While many families have finally been able to buy their own homes because of the historically low interest rates of recent years, for an unfortunate few, the dream has turned into a nightmare because of unfair or predatory mortgage lending practices.

These predatory practices often affect borrowers who obtain loans from subprime lenders those that provide credit to borrowers who have some flaw in their credit record due to late payments, too much debt or other similar issues.

In 2000, the US Department of Housing and Urban Development (HUD) released two studies relating to subprime and predatory lending. The key findings of the first study, *Unequal Burden: Income & Racial Disparities in Subprime Lending in America*, showed:

- Subprime loans are three times more likely in low-income neighborhoods than in high-income neighborhoods.
- From 1993 to 1998, the number of subprime refinancing loans increased tenfold.
- Subprime loans are five times more likely in black neighborhoods than in white neighborhoods.
- Homeowners in high-income black areas are twice as likely as homeowners in low-income white areas to have subprime loans.

In June of 2000, HUD joined with the US Department of the Treasury and released the *Joint Report on Recommendations to Curb Predatory Home Mortgage Lending*. This report identified "too frequent abuses in the subprime lending market. These abuses tended to fall into four main categories:

- Loan Flipping - Some mortgage originators refinanced borrowers' loans repeatedly in a short period. With each successive refinancing, these originators charged high fees,

including sometimes prepayment penalties that stripped borrowers' equity in their homes.

- Excessive fees and "packing" - While subprime lending involves higher costs to the lender than prime lending, in many instances the Task Force saw evidence of fees that far exceeded what would be expected or justified based on economic grounds, and fees that were "packed" into the loan amount without the borrower's understanding.
- Lending without regard to the borrower's ability to repay - One troubling practice involved lending based on borrowers' equity in their homes, where the borrowers clearly did not have the capacity to repay the loans. In particularly egregious cases, elderly people living on fixed incomes had monthly payments that equaled or exceeded their monthly incomes. Such loans quickly led borrowers into default and foreclosure.
- Outright fraud and abuse - In many instances, abusive practices amount to nothing less than outright fraud. [HUD] heard many stories from borrowers who testified at the regional forums of fraud perpetrated by unscrupulous mortgage brokers, lenders, home improvement contractors, appraisers, and combinations thereof. Unscrupulous actors in these markets often prey on certain groups - the elderly, minorities, and individuals with lower incomes and less education - with deceptive or high-pressure sales tactics."

Fueled by these two reports, several members of the California Legislature introduced bills in early 2001 aimed at curbing predatory lending practices. Then-Assemblymember Carole Migden introduced AB 489 which was fiercely negotiated between lenders and consumer groups. In the end, a compromise was reached and AB 489 (Chapter 732, Statutes of 2001) was signed into law by Governor Gray Davis.

AB 489 - California's Covered Loan Law

With the enactment of AB 489 in 2001 (Division 1.6 of the Financial Code) and the subsequent clean-up bill (AB 344 (Migden) Chapter 733, Statutes of 2001), lenders who make "covered loans" must meet various requirements that give borrowers additional protections against predatory practices.

Definition of Covered Loans

Covered loans are defined as:

- Consumer loans secured by one-to-four unit residential properties used or intended to be used or occupied as the principal dwelling of the consumer. Covered loans do not include reverse mortgages, open-end lines of credit, consumer credit transactions secured by rental property or second homes, and certain bridge loans.
- A loan in which the original principal balance of the loan does not exceed \$250,000 (this adjusts every five years in accordance with the California Consumer Price

Index) and where one of the following conditions are met:

- ◆ The annual percentage rate (APR) at consummation exceeds the yield on Treasury securities having a comparable maturity by more than eight percentage points, or
- ◆ The total points and fees payable by the consumer at or before the loan closing will exceed 6 percent of the total loan amount.

Points and Fees

Points and fees include:

- All items required to be disclosed as finance charges under Sections 226.4(a) and 226.4(b) (including the Official Staff Commentary) of Regulation Z except interest;
- All compensation and fees paid to mortgage brokers in connection with the loan transaction; and
- All items listed in Section 226.4(c)(7) of Regulation Z (real estate-related fees), but only if the person originating the covered loan receives direct compensation in connection with the charge.

Prohibited Acts and Limitations

The law includes a lengthy list of prohibitions applicable to covered loans. The key provisions include:

- A covered loan cannot include a prepayment fee that extends beyond the first three years of the loan and the amount of the prepayment fee is limited. A covered loan may include a prepayment fee if the originator has offered the consumer another product without a prepayment fee.
- The person who originates the covered loan may not finance a prepayment fee through a new loan originated by the same person.
- A covered loan with a term of five years or less generally may not provide for a balloon payment at maturity.
- A covered loan may not contain a negative amortization provision unless the loan is a first mortgage and the lender discloses various information about the provision.
- A covered loan may not include terms under which periodic payments required under the loan are consolidated and paid in advance from the loan proceeds.

- A covered loan may not contain a default rate of interest.
- A person who originates covered loans may not make or arrange a covered loan unless the person reasonably believes the consumer will be able to make the scheduled payments to repay the obligation based upon a consideration of their current and expected income, current obligations, employment status, and other financial resources other than the consumer's equity in the dwelling that secures the loan. The consumer shall be presumed to be able to make the scheduled payments to repay the loan if, at the time the loan is consummated, the consumer's total monthly debts, including loan payments, do not exceed 55 percent of the consumer's monthly gross income.
- For "stated income loans," the lender's reasonable belief may be based on the income stated by the consumer, and other information in the possession of the person originating the loan after the solicitation of all information that the person customarily solicits in connection with stated income loans.
- A person who originates a covered loan may not pay a contractor under a home improvement contract from the proceeds of a covered loan, other than by an instrument payable to the consumer or jointly to the consumer and the contractor or, at the election of the consumer, to a third-party escrow agent.
- A covered loan may not contain a call provision that permits the lender to accelerate the indebtedness, except as a result of the consumer's default, pursuant to a due-on-sale clause, or due to fraud or material misrepresentation by a consumer in connection with the loan or the value of the security for the loan.
- A licensed person may not refinance or arrange for the refinancing of a consumer loan such that the new loan is a covered loan that is made for the purpose of refinancing, debt consolidation or cash out, that does not result in an identifiable benefit to the consumer, considering the consumer's stated purpose for seeking the loan, fees, interest rates, finance charges, and points.
- A disclosure written in 12-point font or larger containing mandated text and entitled "CONSUMER CAUTION AND HOME OWNERSHIP COUNSELING NOTICE" must be provided to the consumer no later than three business days prior to signing the loan documents for the covered loan.
- A person who originates a covered loan may not steer, counsel or direct any prospective consumer to accept a loan product with a risk grade less favorable than the risk grade that the consumer would qualify for based on that person's then-current underwriting guidelines. A broker who originates a covered loan may not steer, counsel or direct any prospective consumer to accept a loan product at a higher cost than that for which the consumer could qualify based on the loan products offered by the persons with whom the broker regularly does business.

- A person who originates a covered loan may not avoid the application of the new laws by structuring a loan transaction as an open-end credit plan for the purpose of evading the provisions of the new law if the loan would have been a covered loan had it been structured as a closed end loan; or dividing any loan transaction into separate parts for the purpose of evading the provisions of the new law.
- A person who originates covered loans may not make a covered loan that finances points and fees in excess of \$1,000 or 6 percent of the original principal balance exclusive of points and fees whichever is greater.

Failure to Comply

A compliance failure that is not willful or intentional and results from a bona fide error (e.g., clerical, calculation, computer malfunction and programming and printing errors), and occurs notwithstanding reasonable procedures adopted to avoid those errors is corrected no later than 45 days after receipt of the complaint or discovery of the error, the originator of the covered loan in question will avoid liability for the failure. An originator may be jointly liable for a violation of these provisions by a broker if the originator knew of and showed reckless disregard for the broker's violation.

Enforcement

The covered loan law is enforced by DRE for mortgage brokers, DOC for licensed residential mortgage lenders and licensed finance lenders and DFI for state-chartered commercial and industrial banks and savings associations and credit unions. The Attorney General is given specific enforcement authority.

Any person who willfully and knowingly violates any provision of the new law shall be liable for a civil penalty of not more than \$25,000 for each violation. The licensing agency may also include a claim for relief in addition to the penalties, including a claim for restitution or disgorgement.

A failure to comply gives a consumer a right to actual damages plus attorney's fees and costs. A willful and knowing violation gives the consumer the right to the greater of actual damages or \$15,000, plus attorney's fees and costs. A judge may also award punitive damages in a consumer action.

Subprime Lending

Although there is no single source that tracks covered loan volume in California, anecdotal evidence indicates that it is a small percentage of the overall mortgage market. Most of the large, national subprime lenders in the market are not making covered loans, but are still lending to borrowers with impaired credit.

Generally speaking, subprime lending can be defined as lending to borrowers with elevated credit risk. “Conforming” or “prime” loans are typically made to borrowers who have a solid credit history and a demonstrated capacity to repay their loans. Subprime loans, on the other hand, are typically made to borrowers who have impaired credit or a less certain ability to repay the loan.

Twenty years ago the subprime mortgage market barely existed. There were a few lenders and brokers who offered these loans, but for the most part, borrowers with credit problems simply could not get a mortgage. This left millions of Americans unable to purchase a home or forced them to sell if they got into financial straits.

Homeownership has hit record-high levels in recent years largely due to a sustained period of record-low interest rates. But many experts also feel that the expansion of subprime lending has contributed to the gains in homeownership.

The growth of the subprime market can be attributed to several factors, including federal deregulation of the mortgage rates, the expanding use of credit scores and technological advances. In addition, as prime mortgage lending became more competitive, banks and other traditional mortgage lenders sought higher profits in the subprime market.

Most important to the growth of the subprime market, however was the creation of a secondary market for subprime loans. In the early 1990s, Wall Street's acceptance of mortgage-backed securities comprised of pools of subprime loans greatly increased. A few years ago, Fannie Mae and Freddie Mac began purchasing these loans as well. These market-based activities have provided lenders with the funds needed to make new mortgages, thus bringing additional capital into the subprime arena.

In 1994, the subprime mortgage lending was only \$35 billion. By 2003, the market had grown to \$330 billion. Nationally, in 2003 the subprime market was 9 percent of the total mortgage market, but in California, subprime lending was 13.3% of the market. That share may be growing. In 2004, the prime mortgage market was sluggish, but subprime lending more than doubled in California to \$197 billion.

While consumer groups applaud the fact that more families have access to credit, they have consistently expressed concerns that the subprime industry is selling people higher-priced loans when they could qualify for prime loans.

Not surprisingly, foreclosure rates are higher for subprime borrowers. In mid-2004, 4.6 percent of subprime loans were in foreclosure compared to 0.5 percent for prime loans. Consumer groups worry that when interest rates rise, too many subprime borrowers will find themselves saddled with loans they cannot afford and the foreclosure rates will climb even higher.

Other Federal Laws Governing Mortgages

In addition to California's covered loan law and the various laws providing for the licensing of those who offer mortgage loans, all mortgage lenders must also comply with an array of

federal laws. The primary laws include the Home Mortgage Disclosure Act, Truth in Lending Act, the Home Ownership and Equity Protection Act and the Real Estate Settlement Procedures Act.

Home Mortgage Disclosure Act (HMDA)

Enacted by Congress in 1975, the HMDA was created in order to make more information about mortgage lending available in the public domain. HMDA requires financial institutions, both depository and non-depository, to report annually various information about home loans including the size, type and purpose of loan, the lien status and other data.

HMDA is implemented by the Federal Reserve Board's Regulation C. This regulation provides the public loan data that can be used to assist:

- In determining whether financial institutions are serving the housing and lending needs of communities they serve;
- Public officials in making decisions about where public investments are needed in order to bring in private investment to underserved areas;
- In identifying possible discriminatory lending patterns or "redlining".

The HMDA reporting requirements have changed recently. Under the new rules, lenders are required to report all mortgages with an annual rate that exceeds the Treasury rate by 3 percentage points for first mortgages or 5 percentage points for subordinate loans.

These new standards are expected to cover about 20% of all mortgages. HMDA data previously showed only the frequency of denied loan applications among racial groups. This new data will be publicly available after March 31.

Truth in Lending Act (TILA)

The Truth-in-Lending Act, enacted by Congress in 1968, requires virtually every lender extending credit to disclose the terms and costs of all loan plans, including the annual percentage rate (APR) and points and fees. In addition, the lender must disclose the total of the principal amount being financed, the payment due date and all of the terms and conditions governing the loan.

TILA also requires lenders who advertise to meet various requirements, including:

- Specific credit terms in the ad must be made available to applicants.
- If an advertisement includes a rate, it must state the rate as an APR using that term. This rate takes into account additional costs incurred, such as fees and points, in the first year

of the loan.

- If the annual percentage rate may be increased after the loan is closed, the advertisement must state that fact.
- The only other rate allowed in the ad is a simple annual rate or periodic rate that is applied to an unpaid balance. It may be stated in conjunction with, but not more conspicuously than, the APR.

TILA also provides consumers with the right to cancel certain real estate lending transactions within three days.

Home Ownership and Equity Protection Act (HOEPA)

In response to reports of abusive lending practices, Congress amended TILA by enacting the Home Ownership and Equity Protection Act of 1994. HOEPA identifies a class of high-cost mortgage loans and provides protections for borrowers from loan agreements that are likely to result in default and the loss of their homes.

A loan is covered by HOEPA if it meets the following tests:

- For a first-lien, the APR exceeds by more than eight percentage points the rates on Treasury securities of comparable maturity;
- For a second-lien, the APR exceeds by more than 10 percentage points the rates in Treasury securities of comparable maturity; or
- The total fees and points payable by the consumer at or before closing exceed the larger of \$510 or eight percent of the total loan amount. Credit insurance premiums for insurance written in connection with the credit transaction are counted as fees.

HOEPA primarily affects refinancing and home equity installment loans that also meet the definition of a high-rate or high-fee loan. It does not include loans to purchase or build a home, reverse mortgages or home equity lines of credit (HELOCs).

HOEPA requires several disclosures that must be provided to the borrower at least three business days before the loan is finalized:

- The lender must give the borrower a written notice stating that the loan need not be completed, even though the loan application has been signed.
- The notice must warn the borrower that because the lender will have a mortgage on the home, the borrower could lose the residence and any money put into it if the borrower fails to make the payments as required.

- The lender must disclose the APR, the regular payment amount (including any balloon payment where permitted), and the loan amount. For variable rate loans, the lender must disclose that the rate and monthly payment may increase and state the amount of the maximum monthly payment.

Under HOEPA, high cost mortgages may not include balloon payments for loans less than 5 years, negative amortization and default interest rates higher than pre-default rates. HOEPA also prohibits most pre-payment penalties and due-on-demand clauses.

Additionally, HOEPA protects borrowers by preventing lenders from:

- Making loans based on the collateral value of the property without regard to the borrower's ability to repay the loan. In addition, proceeds for home improvement loans must be disbursed either directly to the borrower, jointly to the borrower and the home improvement contractor or, in some instances, to the escrow agent.
- Refinancing one HOEPA loan into another HOEPA loan within the first 12 months of origination, unless the new loan is in the borrower's best interest. The prohibition also applies to assignees holding or servicing the loan.
- Wrongfully documenting a closed-end, high-cost loan as an open-end loan.

Real Estate Settlement Procedures Act (RESPA)

Congress enacted RESPA in 1974 as a consumer protection measure. The goal of RESPA was to "effect certain changes in the settlement process for residential real estate that will result in:

- More effective advance disclosure to home buyers and sellers of settlement costs;
- The elimination of kickbacks or referral fees that tend to increase unnecessarily the costs of certain settlement services;
- A reduction in the amounts home buyers are required to place in escrow accounts established to insure the payment of real estate taxes and insurance; and
- Significant reform and modernization of local recordkeeping of land title information."

RESPA requires specified disclosure for borrowers who are obtaining mortgages on one-to-four family residential properties. Those disclosures spell out the settlement costs, outline lender servicing and escrow account practices and describe business relationships between settlement service providers.

RESPA also prohibits certain practices that increase the cost of settlement services. Section 8 of RESPA prohibits a person from giving or accepting any thing of value for referrals of settlement service business related to a federally related mortgage loan. It also prohibits a person from

giving or accepting any part of a charge for services that are not performed. Section 9 prohibits home sellers from requiring homebuyers to purchase title insurance from a particular company.

The Regulation of Mortgage Lenders

Along with the assortment of mortgage lending laws, there are a variety of regulators at both the state and federal level who oversee lenders and administer these laws.

Non-Depository Mortgage Lenders

Department of Corporations (DOC)

In California, non-depository institutions may make mortgage loans under two separate licenses administered by DOC, the residential mortgage lender's (RML) license or a California finance lender's (CFL) license.

The California Residential Mortgage Lending Act was enacted in 1994 to provide a unique license for mortgage bankers that act as loan originators and/or loan servicers. A RML licensee may also serve as a mortgage broker who secures a mortgage loan on behalf of a borrower from a third party lender.

The RML authorizes licensees to make federally related mortgage loans. Those loans are made, insured, guaranteed or assisted in any way by the federal government, made in connection with a US Department of Housing and Urban Development program or intended to be sold by the originating lender on the secondary mortgage market to a government-sponsored enterprise such as Fannie Mae or Freddie Mac.

Applicants for a RML must:

- Be an approved lender and/or servicer from the Federal Housing Administration (FHA), Veterans Administration (VA), Farmers Home Administration (FmHA), Government National Mortgage Association (Ginnie Mae), Federal National Mortgage Association (Fannie Mae);
- Demonstrate a minimum tangible net worth of \$250,000; and
- Maintain a surety bond in the amount of \$50,000.

For each RML, the DOC conducts on-site audits at least every 4 years. Those audits are conducted to determine each licensee's compliance with the provisions of the various laws governing mortgage lenders.

Under the California Finance Lenders Law, "any person who is engaged in the business of making consumer loans or making commercial loans" is a finance lender. Under the CFL Law,

licensees may make first and second mortgages, personal loans and business loans.

A CFL license may be issued to a corporate entity and individual employees are not required to obtain a license. A corporation or person applying for a finance lender license must submit an application to DOC, pay a \$300 initial fee and have a net worth of \$25,000. The DOC reviews all applications to ensure that various requirements are met. In general, the company's principals may not have a criminal history or a history of noncompliance with regulatory requirements.

Once a license is obtained, licensees:

- Are subject to periodic examination that each licensee must pay for;
- Must pay an annual assessment each year;
- Have to file an annual report with DOC;
- Must maintain a \$25,000 surety bond at all times.

In addition to the ability to make loans directly, the CFL Law provides some ability for finance lenders to broker loans as long as the loans are only brokered to other licensed CFLs.

Under the CFL Law, the greatest consumer protections are provided for loans of less than \$5,000 and \$10,000. Few, if any, CFLs make mortgage loans under \$10,000.

Department of Real Estate (DRE)

California's real estate law provides for the licensing and regulation of real estate brokers by DRE. Under the law, licensed real estate brokers may:

- Buy, sell or solicit prospective buyers and sellers of real property;
- Serve as a property manager who leases or rents real property; and
- Serve as a mortgage broker who, on behalf of borrowers or lenders, negotiates loans secured by liens on real property.

In most transactions, the mortgage broker is usually an agent for the purpose of arranging the home loan transaction.

Depository Institutions

Depository institutions (e.g., banks, thrifts and credit unions) may be chartered by the state through the Department of Financial Institutions. Alternatively, these types of institutions may choose a national charter regulated primarily by one of three federal regulators: the Office of the

Comptroller of the Currency, the Office of Thrift Supervision or the National Credit Union Administration.

Regardless of whether they hold a state or federal charter, banks and thrifts are also subject to regulation by the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC).

Department of Financial Institutions (DFI)

The DFI oversees state chartered depository institutions such as banks, credit unions, industrial banks and savings association. These depository institutions make a variety of loans to borrowers including loans on real property. These licensees may also broker mortgage loans to other lenders.

The authority to make mortgage loans is an inherent part of the lending authority as a DFI-licensed financial institution. While the California Financial Code does not contain a "mortgage lending" section with respect to these institutions, their mortgage loans are governed by various laws throughout the Financial Code and by the numerous federal laws that apply to loans on real property and regulate lending practices. In addition, these institutions are subject to all general state laws governing mortgage lending such as the state's covered loan law.

Each DFI licensee is subject to a periodic examination at least once every two years.

Office of the Comptroller of the Currency (OCC)

The OCC charters, regulates, and supervises all national banks. It also supervises the federal branches and agencies of foreign banks.

Of the federal regulators, the OCC has been the most active in warning the institutions it charters against engaging in predatory lending practices. For example, in an Advisory Letter issued in 2003 (AL 2003-3), the OCC concludes:

"National banks may confront risks when they obtain loans through brokers or through purchase transactions that contain or reflect abusive lending practices. . . . Failure to [take affirmative steps to avoid them] could raise serious supervisory concerns, and could result in supervisory or other actions directed against national banks, their operating subsidiaries, and the third-party brokers and originators involved in the transaction."

National Credit Union Administration (NCUA)

The NCUA is an independent federal agency that charters and supervises federal credit unions.

Office of Thrift Supervision (OTS)

The Office of Thrift Supervision (OTS) is the primary regulator of all federally chartered thrift institutions, which include savings banks and savings and loan associations.

Recent Court Cases

***American Financial Services Association v. City of Oakland* California Supreme Court Case No. S119869**

Eight days before AB 489 was signed into law the City of Oakland adopted Ordinance Number 12361, an attempt to regulate predatory lending practices that they believed overtly targeted their jurisdiction due to its concentrations of low income persons, and rising home market.

Oakland found, after gathering testimony and evidence at city council meetings, that predatory lending was widespread and a significant problem in low-income neighborhoods. In the ordinance, Oakland concluded: “there is strong anecdotal evidence that predatory lenders have been deliberately targeting low-income neighborhoods in Oakland through intensive mail and door-to-door solicitations...”

The Ordinance made numerous conclusions and findings as to the harm and damage of predatory lending practices, specifically those practices that exacerbate problems associated with blighted neighborhoods. It is obvious that in creating the Ordinance, Oakland was intent on passing a stringent prohibition on predatory lending irrespective of state action.

Oakland Ordinance 12361

It is undisputed that the Ordinance applied to at least all home loans covered by the State's covered loan law. The Ordinance was clear in its regulation of predatory lending and other practices that are most likely to occur in the sub-prime market. As the Court later found, the Ordinance was not supplementary to state law, but was intended to create a separate legal framework. The Ordinance went much further in many respects than Division 1.6 of the Financial Code, including:

- Defined "high-cost home loan" as meeting either of the following criteria: (1) the annual percentage rate of the loan equals or exceeds (a) by more than 3 percentage points, if the home loan is a first mortgage, or (b) by more than 5 percentage points, if the home loan is a junior mortgage, the rate as established by Fannie Mae and Freddie Mac on a specified date, and; (2) the total points and fees on the loan equal or exceed either 5% of the total loan amount or \$800, whichever amount is greater.
- Regulated high-cost home loans up \$359,650, and capped pre-payment penalties to 3% of the loan amount in the first year, 2% in the second, and 1% of the total in the third year.

- Required the borrower to receive mandatory credit counseling.
- Prohibited a lender from financing excessive points and fees and accelerating the indebtedness of the borrower.
- Prevented refinancing of mortgages originated, subsidized, or guaranteed by a federal, state, or local government, or a nonprofit organization.
- Provided that a person who purchases or otherwise holds a home loan is subject to the same legal liability as the original lender, and allowed civil penalties of up to \$50,000 per violation in addition to current remedies available under current law.
- Exempted federally chartered banks from its provisions.

On October 15, 2001 the American Financial Services Association (AFSA) filed an action against Oakland seeking a declaration that the Ordinance was preempted by state law. The trial court found that the Ordinance was preempted in so far as its exemption of federally chartered lending institutions. The court ordered that the exemption be severed from the Ordinance, but that the remaining portions should stand. Oakland and AFSA cross-appealed the lower court's decision. The Appeals Court reversed the severability order of the lower court and affirmed the judgment in all other respects. The California Supreme Court agreed to hear the case.

The Decision

The California Supreme Court found, in a 4-3 decision, that even though Division 1.6 does not contain explicit preemption language, the Ordinance is preempted by state law. Oakland conceded that predatory lending regulation is of statewide concern, and that if the Ordinance conflicts with state law, then it is preempted.

The Court concluded, based on historical case law and statutory intent, that the State of California had intended to completely occupy the field of predatory lending and thereby the Ordinance conflicts with the State's authority over predatory mortgage lending practices. In outlining its reasoning, the Court points to the criteria used to determine state coverage of an issue. The state expresses its authority through manifest expression of its intent to occupy an area of law, or when one of the following becomes clear:

- The subject matter has been wholly and completely covered as to clearly indicate without hesitation that the subject has become an area of state concern.
- The subject matter has been covered in such a way as to indicate that the concern of the state will not tolerate further local action.
- The subject matter has been partially covered by the state, but the effect of local ordinance on the state outweighs the possible benefit to the local jurisdiction.

Oakland argued that Division 1.6 did not overtly prohibit local jurisdictions from passing their own ordinances. Furthermore, they argued that the problem of predatory lending was so pervasive in the Oakland area that they were obligated to pass more stringent regulation than the State. However, the Court concluded that the State need not explicitly assert its preemption over this issue and that its actions in this area are indicative of its intent to occupy the field.

The Court further determined that only the state has the authority to regulate the mortgage industry, and the state's historical occupation of lending laws demonstrates this point.

The majority opinion, in this case, made its conclusion based on the vast historical case and statutory law available to show the criteria necessary to prove state preemption. However, the dissenting opinion eloquently concludes that just as much historical evidence exists to demonstrate that the State only preempts local measures when legislation unmistakably and explicitly indicates its intent to regulate the subject matter in its entirety.

The dissent points out that the Legislature considered preemption language when drafting and negotiating the statute, yet clearly rejected any such language in the face of an extreme lobbying effort to include language in the statute.

In addition, the majority expressed a view that implied that preemption language was inadvertently left out of the discussion regarding Division 1.6. The dissent strongly disagrees and references statements from the legislative history that show numerous discussions took place on preemption. Since the Legislature obviously considered those circumstances and chose not to include express preemption, then no implied preemption exist.

In an acknowledgment to the authority of locals, the dissent also found that local jurisdictions have a significant interest in regulating areas of subprime and predatory lending not covered by state law.

Prior to the Court hearing this case, the Los Angeles City Council passed a local ordinance similar to Oakland's. In passing the LA Ordinance the justification was similar to Oakland in the prevalence of low income, minority communities falling prey to predatory lending practices. The LA City Council believed that the nature of the problem experienced in their jurisdiction required special consideration beyond the state law. With the ruling in AFSA v. Oakland the L.A. Ordinance was invalidated.

Wolski v. Fremont Investment & Loan **125 Cal. App. 4th 12, December 2, 2004**

In this recent case, Daniel Wolski, the plaintiff, worked with a mortgage broker to obtain an adjustable rate loan from Fremont Investment & Loan (a Department of Financial Institutions licensee). In connection with the loan, Mr. Wolski's mortgage broker received a yield spread premium (YSP) payment of \$3,700 from Fremont.

As described by the court “A Yield Spread Premium is a bonus paid to a broker when it originates a loan at an interest rate higher than the minimum interest rate approved by the lender for a particular loan. The lender then rewards the broker by paying it a percentage of the ‘yield spread’ (i.e. the difference between the interest rate specified by the lender and the actual interest rate set by the broker at the time of origination) multiplied by the amount of the loan.” YSPs must be disclosed to the borrower, but are often paid outside of closing.

When Fremont made the loan, it did not include the YSP in its points and fees calculation. Because the totals points and fees without the YSP were less than 6% of the total loan amount, Fremont did not consider the loan to be a covered loan.

After the loan closed, Wolski discovered that he could have obtained a loan with a lower and fixed rate. Wolski filed suit against Fremont claiming, among other things, that Fremont violated the covered loan law because it failed to make certain disclosures and included a prepayment penalty in the terms of his loan.

Wolski argued that the YSP payment to the broker was a point and fee, and when calculated as such the total points and fees exceeded 6% of the total loan amount. Therefore, his loan was a covered loan. The trial court concluded that the YSP payment was not a point and fee and that the loan was not a covered loan. Wolski appealed. The appellate court upheld the trial court's decision.

The appellate court based its decision on the actual language of the statute: "total points and fees payable by the consumer at or before closing for a mortgage or deed of trust will exceed 6 percent of the total loan amount." Fremont argued that because a YSP is paid by the lender and not the borrower, a YSP falls outside the definition of points and fees because it is not "payable by the consumer."

Wolski contended that by paying a higher interest rate, he did indeed pay for the YSP. The Court disagreed with Wolski and sided with Fremont who responded that the YSP is not "payable at or before closing."

The Court noted that the phrase “at or before closing” was unambiguous and “does not include payments made after closing and over the life of the loan such as interest.”

Since the Appellate Court decision in this case, Consumers Union (CU) on behalf of themselves, the California Reinvestment Coalition, ACORN and California Alliance for Retired Americans, has written to the Court in support of the Appellant’s Petition for Rehearing. In the letter, CU argues that the Court was not apprised of the fact that it was the intent of the Legislature to include YSPs in the points and fees calculation. Nor was the Court aware of “administrative interpretations” by DRE that were contrary to the Court’s decision.

In support of this argument, CU provided the Court with a copy of a March 5, 2004 letter from Thomas Pool, Assistant Commissioner, Legislation & Public Information for DRE. In the letter, Pool responds to a question about whether YSPs should be included in the points and fees calculation under Section 4970, et seq., of the Financial Code:

“After convening a working group to study the issue, and after meeting with consumer and industry groups, it is the Department’s conclusion that any and all back-end/” YSP” compensation payable to a mortgage broker at or before close of a loan must be included when calculating ‘points and fees’ witing the meaning of Section 4970(b)(1)(B) of the PLA [Predatory Lending Act].”

Industry representatives acknowledge that this working group existed, but they have argued that the conclusion of the group was in error because the language of AB 489 specifically did not include YSPs in the points and fees calculation. Section 4970(c)(1) says:

- (c) "Points and fees" shall include the following:
 - (1) All items required to be disclosed as finance charges under Sections 226.4(a) and 226.4(b) of Title 12 of the Code of Federal Regulations, including the Official Staff Commentary, as amended from time to time, except interest.

The Official Staff Commentary to Regulation Z states in part, "In determining "points and fees" for purposes of this section . . . [m]ortgage broker fees that are not paid by the consumer are not included." (Commentary para. 32(b)(1)(ii)-1.)

At this point, the Court has given no indication when it will make a determination on the Petition for Rehearing.

Anti-Predatory Lending Laws in Other States

Over 25 states and a number of local jurisdictions have adopted anti-predatory lending laws and ordinances in the last five years. The elements of each statute or ordinance vary, but generally they provide for consumer protections that go beyond federal law.

Often, state laws define “high-cost loans” more stringently than HOEPA. In other words, a high-cost loan may have an APR threshold that is lower than the APR established for a “high-cost loan” under HOEPA. Similarly, many states categorize a high-cost loan as one where the “points and fees” trigger is lower than HOEPA’s.

In addition, some of these laws include “assignee liability” provisions which mean that a lender or investor who purchases a loan after it is closed (a “holder in due course”) may be liable to the borrower for any violations of the law committed by the original lender or broker. Some assignee liability provisions have led ratings agencies such as Fitch, Moody’s and Standard & Poor to refuse to rate securities that include high-cost loans from a state because they cannot accurately assess the risk of these securities. When this occurs, some lenders pull out of a market completely or decide not to make any loans that cannot be rated.

Below is a brief overview of three states’ laws: North Carolina, Georgia and New Jersey. North Carolina is highlighted because it was the first in the nation to adopt such a law and it set the stage for others to follow suit. North Carolina is also considered to be a strict law that has

provided strong protections for consumers without driving reputable lenders out of the state. Georgia and New Jersey are included because both states initially passed very restrictive laws that received national attention. Ultimately both states were forced to amend their laws in response to concerns from the ratings agencies and lenders withdrawing from the market.

North Carolina

The North Carolina legislature was the first to establish a statewide, anti-predatory lending law. Enacted in 1999, the provisions of North Carolina's statute contain stringent consumer protection provisions. Yet the legislation was endorsed by all of the state's major financial trade associations as well as the Coalition for Responsible Lending.

The law establishes three basic protections for all home loans:

- Prepayment penalties are prohibited for loans of \$150,000 or less.
- Flipping is prohibited. No lender may repeatedly refinance an existing home loan with upfront fees.
- Lenders may not finance upfront, single premium insurance (e.g., credit life, unemployment or disability).

The law also created a category of loans called "high-cost home loans," which are residential home loans of \$300,000 or less with either a high fee, high rate or a substantial prepayment penalty. The triggers are as follows:

- A high fee loan is where the borrower is charged more than 5 percent of the loan amount in upfront points, fees, or other charges. This 5 percent does not include escrows collected at closing or fees for appraisal, attorney, credit report, etc. that are paid to third parties. The 5 percent does include fees paid directly by the borrower to a mortgage broker, but it does not include the YSP. It also includes any prepayment penalty in excess of 1 percent.
- A high interest rate loan mirrors the threshold established under HOEPA and is defined as a loan where the borrower is charged an interest rate that is 8% (as of October 2002) more than the comparable Treasury bond rate.
- A substantial prepayment penalty is longer than 30 months or where more than 2% of the amount prepaid.

For high-cost home loans, the protections include:

- Upfront fees cannot be financed.

- Prior to loan closing, all borrowers seeking a high-cost home loan must obtain counseling from a home loan counselor.
- Balloon payments and loans with negative amortization are prohibited.
- The lender may not make the loan without consideration of a borrower's ability to repay.

Although the statute does not specifically include assignee liability, a violation of the law is deemed usurious. Under the North Carolina Constitution, anyone who takes usurious payments can be liable for violations of the law.

Georgia

In October 2002, the Georgia Fair Lending Act (GFLA) went into effect. The anti-predatory lending restrictions imposed by GFLA at that time were considered the nation's toughest. Under the law, the consumer protections varied depending upon whether the loan was a "home loan," a "covered home loan" or a "high-cost home loan." The law allowed for unlimited punitive damages when lenders did not comply with the provisions and that liability extended to holders in due course.

Once GFLA was enacted, the market response was swift. Fitch, Moody's and S&P refused to rate securities that included Georgia loans. Fannie Mae and Freddie Mac announced that in January 2003 it would no longer purchase high-cost home loans made in Georgia. All of this led many lenders to pull out of the market.

In addition, the OCC, OTS and NCUA found that federal law preempted the Georgia law. Therefore, federally chartered depository institutions were not subject to the law's provisions.

In response to these actions, the Georgia Legislature amended GFLA in early 2003. The amendments removed many of the GFLA's ambiguities and eliminated covered loans.

With the amendments, assignee liability is limited to one year after the date of closing and the assignee has no liability if it can prove by a preponderance of evidence that it exercised reasonable due diligence at the time of the purchase of the loan or within a reasonable time thereafter. Lawsuits against assignees are limited to individual (not class) actions.

In response to federal preemption, the amendments also gave state-chartered depository institutions parity with their federally-chartered competitors by excluding them from the law.

The key provisions of GFLA still provide some protections for all home loans and additional restrictions on high-cost home loans. For example, lenders who provide home loans may not:

- Make a home loan that finances single premium insurance.

- Charge a borrower a late payment charge unless the payment is past due for ten days or more, and the charge does not exceed 5 percent of the amount of the late payment. Other restrictions on late payments are also included.
- Charge a fee for providing the borrower with the balance due to pay off a home loan.
- Engage in flipping.

A high-cost home loan includes one or more of the following:

- An APR that equals or exceeds the rate set in HOEPA
- A loan where the total points and fees payable exceed: (1) 5 percent of the total loan amount if the total loan amount is \$20,000.00 or more or (2) the lesser of 8 percent of the total loan amount or \$1,000.00 if the total loan amount is less than \$20,000.00. Points and fees include YSPs and some prepayment penalties.

For high-cost home loans, the key provisions prohibit lenders from:

- Including negative amortization and prepayment penalties that extend beyond two years.
- Requiring more than two periodic payments to be paid in advance from the loan proceeds.
- Making a loan unless the borrower has received counseling on the advisability of the loan.
- Making direct payment to home improvement contractors out of the loan proceeds, instead of (1) to the borrower, (2) jointly to the borrower and contractor, or (3) to a third-party escrow selected by the borrower.
- Making a loan unless a reasonable creditor would believe, at the time the loan is consummated, that the borrower will be able to make the scheduled payments.

New Jersey

When New Jersey enacted its law, the New Jersey Homeownership Security Act of 2002, many of the provisions were similar to the Georgia law. As in Georgia, lenders and the ratings agencies expressed concerns when the law was passed. The Act was later amended in 2004 in a way that eased some lenders' concerns.

However, the ratings agencies still refuse to rate securities that include high-cost loans from the state because assignee liability exists for six years following the closing of the high-cost home loan or for the term of the loan in cases where foreclosure has been commenced, the debt has been accelerated, or the high-cost home loan is 60 days in default.

The amendments eased some restrictions including eliminating a category of loans called “covered loans” which contained some consumer protections, but not as many as “high-cost loans.” The amendments also removed specific prohibitions on flipping that were viewed as ambiguous. However, the amended law also lowered the points and fees trigger for high-cost loans from 5 percent to 4.5 percent.

Currently, New Jersey’s law provides some limitations on all home loans and a number of restrictions on high-cost home loans. For all loans, the following practices are prohibited:

- Financing certain credit insurance premiums or debt cancellation agreements.
- Recommending or encouraging default on an existing mortgage loan.
- Charging a late payment fee in excess of 5% of the amount of the payment due.
- Charging a late fee in excess of 5% of the past due payment.
- Accelerating indebtedness at the creditor's sole discretion.
- Charging a fee for borrower's payoff balance information.

A high-cost home loan is a home loan for up to \$350,000 (adjusted annually) in which the rate exceeds the triggers established under HOEPA or the points and fees exceed 4.5 percent of total loan amount for loans over \$40,000 (higher triggers are established for smaller loans). For high-cost home loans, the key provisions prohibit lenders from:

- Including most balloon payments and any negative amortization.
- Requiring more than two periodic payments to be paid in advance from the loan proceeds.
- Lending to a borrower who finances points and fees without the borrower first counseling from a loan counselor.
- Making direct payment to home improvement contractors out of the loan proceeds, instead of (1) to the borrower, (2) jointly to the borrower and contractor, or (3) to a third-party escrow selected by the borrower.
- Charging points and fees if the proceeds of a high-cost home loan are used to refinance an existing high-cost home loan with the same lender.
- Financing points and fees in excess of 2% of the total high-cost home loan amount.

Potential Federal Legislation

With over half the states enacting anti-predatory lending laws, Congress has also considered legislation in this area. Last Session, Representative Bob Ney (R-Ohio) introduced H.R. 833, the "Responsible Lending Act of 2003" which would have invalidated all state and local laws.

This session, Ney and Paul E. Kanjorski (D-Pennsylvania) have announced they will introduce a bi-paritsan measure that will create a uniform national law for subprime lending. It is widely expected this legislation will include prohibitions on predatory practices and mandate some consumer education requirements. Like H.R. 833, the legislation is expected to preempt state and local laws.