WRITTEN STATEMENT OF WEBB A. BREWER

ATTORNEY AT LAW
BREWER & BARLOW, PLC
COUNSEL FOR PLAINTIFFS IN CITY OF MEMPHIS V. WELLS FARGO

BEFORE THE
HOUSE JUDICIARY COMMITTEE
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

FIELD BRIEFING ON HOME FORECLOSURES IN MEMPHIS

CECIL C. HUMPHREYS SCHOOL OF LAW
UNIVERSITY OF MEMPHIS
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Chairman Cohen and Members of the Subcommittee:

Thank you for inviting me to share my thoughts about the foreclosure crisis in the Memphis area. It’s a subject to which I’ve given a lot of thought and attention over the last decade. I hope I can provide some helpful insights.

INTRODUCTION

As Litigation Director at Memphis Area Legal Services, I began working on cases involving abusive lending practices in the 1990s long before I had heard the term predatory lending. In my earliest exposure, smaller obscure regional lenders were making loans with outrageous terms. Initially, these were mostly second mortgage loans and were often financing home improvement work for one of several notorious local home improvement companies. Those companies would aggressively solicit business door-to-door, especially in minority neighborhoods, and arrange financing for grossly overpriced “home improvements”. I put that phrase in quotations because the work was usually extremely shoddy and was often never finished, leaving the property in much worse shape than before the work.

The victims of these loans were often elderly African-American women who did not understand the loan transaction at all. The “closings” (again I use quotations because that term implies a far more dignified transaction than what was) were in the borrowers’ home and they generally didn’t even understand they were giving a mortgage in their home. In frustration about the quality of the work the homeowner would often just stop paying the mortgage and would ultimately get into foreclosure. We called the practice “equity skimming” in those days because the lenders were often able to acquire the property for the small balance on the purchase loan.

Over the years I have litigated dozens of predatory lending cases, starting with some simpler state court cases and graduating to more complex multi-party federal litigation based upon theories as diverse as the Fair Housing Act and the civil RICO statute. Because of my extensive work in the area, I have become known in some circles as something of an expert on the subject; however, I didn’t set out to become an expert on predatory lending and foreclosures- the issue found me.

I have watched as this small but toxic “fringe” lending industry metastasized into a multi-billion dollar international business that attracted the world’s largest financial institutions and threw the world economy into chaos. The second mortgages morphed into equity or refinance loans and the small regional lenders became large national corporations with names known by everyone that made sub-prime loans worth billions of dollars each year. Sub-prime lending eventually moved into purchase loans to finance new homes.

These were risky, high-cost loans that are loaded with features like adjustable interest rates, excessive broker and origination fees, and prepayment penalties. Mortgage brokers were paid kickbacks or "Yield Spread Premiums" for duping customers into loans with higher interest rates than they qualified for based on their credit score. The excessive fees and kickbacks gave loan originators and brokers incentive to falsify loan applications to justify larger loans than the borrower could afford. It also gave them incentive to mislead borrowers about the terms of the loans they were getting.

The business became so good that, by the turn of the century, huge, prestigious banks jumped headlong into the market and Wall Street firms were packaging and trading these loans as fast as they could. It is almost impossible to overstate the effects of irresponsible lending and the foreclosure tidal wave it has wrought.

RACE DISCRIMINATION AND REVERSE REDLINING IN SUB-PRIME LENDING

From my perspective, regardless of how pervasive sub-prime lending became, predatory lending began in the African-American community and it is that community that has suffered the brunt of the devastation. As I wrote in two recent op-ed pieces for a local newspaper predatory lending has done more than anything else to reverse financial gain in the African-American community since the beginning of the Civil Rights movement. Decades of expansion of homeownership percentages have been reversed by the foreclosure crisis and personal wealth has plummeted at an astounding rate. It is the civil rights issue of this era.

Home Mortgage Disclosure Act data shows an extremely pronounced concentration of "high cost" loans in minority communities. An examination of ten Zip Code areas in Shelby County with a high concentration of African- American residents (more than 70% according to the 2000 census) reveals that 56 % of loans made in those areas in one recent year were sub-prime loans as compared to 36 % for Shelby County as a whole. By contrast, in 14 Zip Code areas with high concentrations of Caucasian residents (more than 70 %) only 24 % of the residential mortgage loans made in the same year were sub-prime loans. Reliable research indicates that sub-prime loans are seven to ten times more likely to end in foreclosure than prime loans. Not surprisingly, then, more than 4% of the owner-occupied homes in predominantly African-American Zip Code areas were foreclosed in 2008 compared to 1% of the owner-occupied homes in predominantly Caucasian Zip Code areas. It is easy to see that this pattern, spread over a decade has caused exponentially greater damage in the African- American community than elsewhere.

Lenders argue that this concentration of high-cost loans and foreclosures is not evidence of discriminatory lending, but of the financial position or credit ratings of the members of the community. I learned from discovery in my predatory lending litigation; however, that there is very purposeful targeting of minority communities (particularly the African-American community in Memphis) for risky, high-cost loan products. This practice is called "reverse redlining" and it involves aggressively peddling toxic loan products in areas where prime loans were historically unavailable because of "redlining". This is done through such practices as saturating minority-oriented radio and television programming with advertising; targeting areas with high percentages of minority residents for mailings and "cold calls"; making presentations in African-American churches and other institutions; and developing relationships with African-American mortgage brokers. There is abundant evidence that sub-prime lending is not "colorblind", but that it's very origins were based on exploiting people who had limited prime credit opportunities and, because of that, limited experience and sophistication in matters of banking and finance.

Emerging data is driving home the consequence to the wealth of individual families, especially those of color. A recent New York Times article about the effect of foreclosures on African- Americans in Memphis cited a study by the Economic Policy Institute showing that as of the end of 2009 median white wealth had dipped 34 percent to $94,600 while median black wealth had dropped by 77 percent to $2,100. That is the single most depressing statistic I have ever read.

According to a recent study by the North Carolina based non-profit Center for Responsible Lending called Foreclosures by Race and Ethnicity: the Demographics of a Crisis, the loss of wealth in “communities of color” may be as great as $350 billion, an amount greater than the costs paid by Gulf Coast states in response to Hurricane Katrina. That study found that for every 100 African-American homeowners, 11 have either lost their homes to foreclosure or at imminent risk of foreclosure. For Latino families the figures are even worse, as 17 of every 100 homeowners are affected by foreclosure.

It is not just families who have gotten bad loans that are harmed by irresponsible lending. The cumulative effect of several foreclosures in a neighborhood adversely affects the values of all the rest of the homes. In some neighborhoods, values have fallen by well over 50% over the past few years. This affects people who didn’t even take bad loans. Where their homes may have been a $100,000 asset a few years ago they may be worth only $30,000 or $40,000 now. Quality of life may have plummeted right along with property values. Many foreclosed houses remain vacant for long periods and become magnets for crime, vagrants, and fires.

Ultimately, this leads to blighting, which harms the individuals who lose their homes, neighbors whose property values and quality of life suffer, and, in the end, the entire community suffers.

CITY OF MEMPHIS AND SHELBY COUNTY V. WELLS FARGO

In December of 2009, the City of Memphis and Shelby County initiated a federal lawsuit against Wells Fargo, based upon the Fair Housing Act, alleging that they had been damaged by blighting as a result of the Wells Fargo's targeting of African-American communities for risky high-cost loans that resulted in foreclosure at extraordinarily high rates.

Fifty-one percent (51%) of loans made by Wells Fargo to African-American households in Shelby County between 2004 and 2008 were sub-prime loans, while only seventeen percent (17%) made to Caucasians between the same years were sub-prime.

Between 2000 and 2008, the rate at which Wells Fargo loans went to foreclosure (or "death rate") in predominantly African-American neighborhoods was eight times greater than in predominantly Caucasian neighborhoods. This astonishing disparity is twice the overall disparity of four to one in Shelby County. What this means is that while reverse redlining is a pervasive practice in Memphis, Wells Fargo's practices stand out as uniquely discriminatory.

Investigation has revealed that Wells Fargo Financial engaged in very aggressive marketing by making "cold calls" to consumers about whom they had information from prior financing, offering quick cash and loan consolidation. Virtually all of the loans offered were Adjustable Rate Mortgages, known as "2/28" or "3/27" loans with artificially low "teaser rates", which would rise every six months after the initial rate expired. Consumers were often promised that, in addition to cash and debt consolidation, they would get their current interest rate reduced by refinancing with Wells Fargo Financial. In many of these loans, the teaser rate would be lower than their existing rate; however, the interest rate would generally rise by more than six percent over the course of the loan making the real interest rate significantly higher than the current mortgage.

According to Affidavits of former employees filed with the Plaintiffs' Amended Complaint, the adjustable rate feature was almost never explained to prospective borrowers even up through the loan closing. Those consumers who were savy enough to ask if they were getting a fixed rate loan were often told that it was "fixed for three years" and could be refinanced at the end of three years. Others were simply told falsely that the rate was fixed. These practices have been corroborated by sworn statements from Wells Fargo borrowers.

Other unfair and deceptive practices associated with the making of the loans included failing to inform borrowers that their monthly payments didn't include escrow payments for taxes and insurance; failing to inform borrowers that they would owe a balloon payment at the end of their promissory note; making loans that the borrower didn't have a reasonable ability to repay by computing the loan to income ratio using only the payment under the artificially low teaser rate; and, in some instances, falsifying loan applications. All of these practices contributed to the extraordinarily high death rate in Wells Fargo loans in the African-American community.

As a result of revelations about these unfair and deceptive acts and practices, the Plaintiffs have alleged also alleged sweeping violations of the Tennessee Consumer Protection Act.

Analysis of foreclosures resulting from Wells Fargo loans reveals that many of the properties have remained vacant for extended periods of time, especially those in predominantly African-American neighborhoods. These vacant properties that result from foreclosure of Wells Fargo loans are a major contributor to blighting.

The Fair Housing Act provides for very broad standing to sue by any person or entity that has been damaged by discriminatory practices. The Supreme Court has repeatedly held that local governments have standing to sue under the Fair Housing Act if they can show they have suffered a "distinct and palpable" injury as a result of discriminatory conduct.

In this case, Memphis and Shelby County have incurred significant expenses as a direct result of blighting caused by Wells Fargo foreclosures.

First, post-foreclosure vacant properties are a public nuisance and result in significant housing code enforcement costs for activities ranging from weed and grass cutting to boarding up properties to rodent control to demolition of houses. Frequent inspections of vacant properties and sometimes appearances in Environmental Court result in significant administrative expenses as well.

Second, vacant properties are magnets for vagrants and illegal activity resulting in frequent police calls. This also poses a significant expense to local governments and, ultimately, to taxpayers.

Third, vacant properties often result in fires. A recent study by the Mid-South Peace and Justice Center has found that a fire in a vacant property can cost local governments as much as $17,500.

At the same time, foreclosures and vacancies result in significant reductions in property values, which reduces property tax revenue. Tennessee does not have a state income tax and local governments are highly dependent on property taxes to provide municipal services.

Almost as significant as post-foreclosure vacancies to neighborhood property values is the ultimate disposition of the property after foreclosure. An analysis of Wells Fargo foreclosed properties since 2001 by the University of Memphis' Center for Community Building & Neighborhood Action reveals another significant difference based upon the racial demographics of a neighborhood. In predominantly white neighborhoods (80% or more Caucasian households) 71% of the foreclosed properties ultimately became owner-occupied residences, while in predominantly African-American neighborhoods (80% or more African-American) only 34% are now owner-occupied. The shift in percentage of owner-occupied homes to rental units also has an adverse effect on property values and quality of life.

The Fair Housing Act provides for broad equitable and remedial relief as well as monetary damages for violations. The local governments are seeking three main forms of relief through this litigation.

First, they seek injunctive relief to require Wells Fargo and its agents or sucessors in interest to participate in court-supervised mediation as a prerequisite to foreclosure of residential mortgages. Tennessee is a non-judicial foreclosure state and lenders or holders of Deeds of Trust can proceed directly to foreclose. Although Wells Fargo is a participant in the HAMP program, there is a wealth of information to suggest that bona fide proposals to modify or restructure mortgages are being ignored or rejected by Wells

Fargo. Beyond that, Wells Fargo's HAMP program does not consider the instances of fraud, misrepresentation, or other illegal lending practices when considering modification proposals. Such mediation programs have been successful as special projects in judicial foreclosure states and this relief could help put a tourniquet on the ever-increasing numbers of foreclosures.

Second, the city and county seek compensatory damages to shift that portion of the cost of blighting they have incurred as a result of it's discriminatory conduct to Wells Fargo. They also seek punitive damages as appropriate to punish Wells Fargo for intentional and willful discriminatory acts. Such shifting of cost will ultimately benefit victims of irresponsible lending and taxpayers.

Third, we seek prospective remedial relief in the nature of requiring Wells Fargo to make quality "A" loans to qualified borrowers in African-American neighborhoods as they do in white neighborhoods.

CONCLUSION

Based upon my experience as an attorney who has devoted a great deal of time to litigating predatory lending cases, there are a number of popular misconceptions about the foreclosure crisis. The most basic one is that the degree to which fraud, deceit, and predatory lending practices have contributed to the crisis is consistently underestimated. For example, many say that the economic downturn is largely responsible; however, so many borrowers were put into loans in which they were paying much too high a percentage of their income for their mortgage. I have seen countless examples of families who were paying well over fifty percent of their income for their monthly mortgage payment. This was generally the result of deceit about the existence of an adjustable rate feature in the mortgage. If that family suffers the slightest decrease in income it is likely to go into default.

Similarly, a major reason the HAMP modification programs are not working is that lenders are not willing to recognize that many borrowers owe far more than the value of their home because of a fraudulent appraisal. Unless this is recognized and an adjustment made to the principal indebtedness, a loan modification will not work.

From my perspective, it will likely take mass litigation to curtail the foreclosure crisis and restore the housing market to a healthy state.