



Testimony of John Taylor

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**Before the House Financial Services Committee
on Accelerating Loan Modifications, Improving
Foreclosure Prevention and Enhancing
Enforcement**

**Testimony also on behalf of
National Consumer Law Center**

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Introduction

Good afternoon, Chairman Frank and Ranking Minority Member Bachus. I thank you for the honor and opportunity to present testimony today on behalf of the National Community Reinvestment Coalition (NCRC) on this important topic. NCRC is the nation's association of 600 community nonprofit member organizations dedicated to increasing access to capital and credit for working class and minority communities.¹ I am also testifying today on behalf of the National Consumer Law Center's low-income clients.²

Over the last several months, NCRC has testified a number of times, warning that the nation stood on the edge of a mortgage tsunami. When we testified in the spring, we heard the regulatory agencies tell us that the "contagion" would not spread beyond the subprime market. As spring turned into summer, it was clear that the "contagion" had spread broadly throughout the housing market. The industry has flooded the market with

¹ **The National Community Reinvestment Coalition (NCRC)** is an association of more than 600 community-based institutions that promote access to basic banking services, including credit and savings, to create and sustain affordable housing, job development and vibrant communities for America's working families. Our members include community development corporations, local and state government agencies, faith-based institutions, community organizing and civil rights groups, minority and women-owned business associations and social service providers from across the nation. Their work serves primarily low- and moderate-income people and minorities.

NCRC pursues its work through a variety of partnerships and programs. Our National Homeownership Sustainability Fund leverages the expertise of a national network of mortgage finance advisors. They work with servicers and lenders, on behalf of homeowners, to keep working families from losing their homes to foreclosure. NCRC's National Training Academy provides training and technical assistance on topics such as understanding how to use CRA, fair housing and foreclosure prevention. Our Economic Justice Campaign sites pilot innovative community partnerships to enhance the delivery of financial, technical, and social services to individual consumers, homeowners, and small business. NCRC represents its members before Congress, federal regulatory agencies and the press. NCRC routinely testifies before the U.S. Congress, and meets regularly with the leadership of banking and lending regulatory agencies.

² **The National Consumer Law Center, Inc. (NCLC)** is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including *Truth In Lending*, (5th ed. 2003) and *Cost of Credit: Regulation, Preemption, and Industry Abuses* (3d ed. 2005) and *Foreclosures* (1st ed. 2005), as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low-income people, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of all federal laws affecting consumer credit since the 1970s, and regularly provide extensive comments to the federal agencies on the regulations under these laws.

exotic mortgage lending such as payment-only Adjustable Rate Mortgages (ARMs), many of which were originated in the prime market, and subprime “hybrid” 2/28 and 3/27 ARMs. These exotic and/or high-cost mortgages overwhelm borrowers when interest rates shoot up after an introductory time period. The sum total of the problematic lending is that up to 2 million mortgages may end up in foreclosure this year and in 2008, costing about \$300 billion dollars. Foreclosures may be even substantially higher; we are receiving industry updates of more than 450,000 foreclosures every quarter.

We recently said that we have not seen anything like this in modern history. Given the national crisis, strong and decisive legislation is desperately needed. H.R. 3915 began with the best of intentions and includes comprehensive protections against abusive lending.

A significant flaw with the legislation, however, is the bill's preemption, which eliminates the core state claims many borrowers currently use to protect themselves from unaffordable loans without providing a viable alternative. The current language appears to prevent homeowners from asserting state common law and statutory claims that are at the heart of most current, meaningful litigation and foreclosure defense actions on behalf of consumers: unconscionability, unfairness and contract claims.

The preemption of state law is exacerbated because the legislation does not contain effective enforcement mechanisms. The bill insulates those that hold the loans, the very parties that funded these abusive products and created a market for predatory loans. Most importantly, the various safe harbors in the bill provide insufficient incentive for the market to change. The comprehensive protections amount to empty promises if they cannot be enforced vigorously.

The House Financial Services Committee asks whether empowering federal agencies would bolster enforcement of HR 3915. The specific mechanism suggested is unlikely to achieve this desired result. In addition, while offering immunity from liability for modifying loans may have some surface appeal, it runs the risk of perpetuating unsavory practices. NCRRC proposes an alternative enforcement mechanism: providing borrowers with the right to seek redress. There should be no safe harbors preventing borrowers from seeking their rights under law.

Moreover, instead of a dangerous blanket immunity for servicers and other players engaging in loan modifications, Congress should require loss mitigation prior to foreclosure to ensure borrowers get the best chance to keep their homes. In addition to these issues, discussed further below, we also would like to identify two other measures that would substantially help borrowers in distress. First, the House should pass H.R. 3609, which would allow borrowers to discharge mortgage debt in bankruptcy beyond the fair market value of the house. Second, a stay on foreclosures would provide a real opportunity for servicers to develop better loan modification plans for many borrowers and for policymakers to implement strong measures to support this process. The loan modification plans must involve servicers working with nonprofit agencies to engage in

meaningful loan modifications. This infrastructure (servicer working with nonprofits) currently exists only on a limited basis.

Let us not make the mistake of undermining the effectiveness of consumer protection legislation because we are so concerned about not hurting industry. Congress needs to pass laws that genuinely protect the American taxpayer from the corporate greed and malfeasance so clearly demonstrated over the past several years. Also, legislation should not require middle-class families to be rich or lawyers to protect their rights. Wall Street, banks, and mortgage brokers are protected by not violating the law; these actors should not be protected by setting such a high bar against liability that American families cannot protect themselves from the abusive, bad actors.

Federal Enforcement of Pattern and Practice is Not an Effective Enforcement Mechanism

The pattern and practice amendment has admirable intentions of bolstering enforcement, but it provides a remedy for borrowers which is very difficult to achieve, imposes a penalty that is unlikely to serve as a deterrent, and entrusts enforcement to federal agencies that have brought relatively few cases against lenders. We believe that the amendment would not result in much prosecution and may undermine state and private efforts. The result could be that abusive lending will continue unabated.

Pattern and practice cases are time consuming and require a high standard of proof. These cases often require sophisticated statistical analysis that depends on assembling large databases containing several variables. The construction of the databases is a labor-intensive exercise and involves a lengthy legal process of discovery. After constructing the databases, the statistical analysis must prove beyond reasonable doubt that abusive treatment is not due to random chance but is the result of policy. In the civil rights context, several variables capturing the characteristics of the loans and borrowers must be accounted for before a conclusion can be reached that differences in treatment are due to race, gender, or age. A similarly complex analysis must be employed to demonstrate pattern and practice of abusive lending. It takes several months, or years, and considerable resources to succeed in a pattern and practice case.

The history of federal agency pursuit of pattern and practice cases suggests that few of these cases would be successfully concluded. In the last seven years, NCRC found that the Department of Justice (DOJ) has settled just seven pattern and practice cases involving discrimination. Two of these cases entailed automobile lending and credit card lending. Five cases or less than one a year involved discrimination in mortgage lending. The relatively few cases suggest that the cases are complex or reveal a decreased commitment on the part of the federal agencies to pursue these cases.³ Moreover, many

³ Associates National Bank, January 2001; Mid America Bank, FSB, 2002; Fidelity Federal Bank, FSB, July 2002; Old Kent, Fifth Third, May 2004; First American Bank, July 2004; Centier Bank, October 2006; Compass Bank, January 2007

of the cases involved small lenders and less sophisticated issues. The DOJ cases often involved redlining and the disproportionate denials to protected classes whereas today's cases are likely to involve yield-spread premiums, ARMs, prepayment penalties, and other complex loan terms and conditions..

The investigations involving the Home Mortgage Disclosure Act (HMDA) pricing data illustrate the difficulty of bringing pattern and practice cases. The federal agencies have been unable to use a powerful new tool, HMDA pricing data (first available with the 2004 data), to prosecute discrimination cases. In September of 2005, the Federal Reserve Board stated that it referred about 200 lending institutions to their primary federal regulatory agency for further investigations based upon the Federal Reserve's identification of significant racial pricing disparities in HMDA data.⁴ An industry publication subsequently quoted a Federal Reserve official as stating that these lenders accounted for almost 50 percent of the HMDA-reportable loans issued in 2004.⁵ In September of 2006, the Federal Reserve Board referred a larger number of lenders, 270, to their primary regulatory agencies for further investigations.⁶ Inconceivably, not a single case of discrimination or civil rights violations have arisen from the roughly 470 Federal Reserve referrals. The federal agencies are either unable or unwilling to bring pattern and practice cases on the basis of pricing discrimination.

The record is clear and incontrovertible that relying on federal prosecution of pattern and practice cases will not be effective as a major means of enforcing a federal law. Unfortunately, HR 3915 in its present form does not provide significant opportunities for private enforcement. The proposal to add federal enforcement of pattern and practice is well meaning but is unlikely to substitute for a lack of opportunities for private enforcement.

Another unintended consequence of legislating enforcement of pattern and practice is that it may decrease the number of predatory lending cases by creating an unrealistically high standard. State agencies have successfully pursued cases on standards that are less strenuous than a pattern and practice standard. After a federal pattern and practice standard is established, defendants may be able to convince courts that plaintiffs will need to win cases using the pattern and practice standard. Consequently, Attorneys General and state-level departments of banks will have a much more difficult time winning cases with less vigorous standards. The end result will be less prosecution of predatory lending.

Establishing a pattern and practice standard is like Congress proposing a consumer protection law requiring an average American to be wealthy and a statistician to enforce

⁴ Robert B. Avery, Glenn B. Canner, and Robert E. Cook, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement*, Federal Reserve Bulletin, Summer 2005,

⁵ Inside Regulatory Strategies, November 14, 2005, p.2.

⁶ Joe Adler, *Big Increase in Lenders with Suspect HMDA Data*, American Banker, September 11, 2006.

his or her rights. A pattern and practice standard is so high that many states, acting on behalf of their consumers, will be unable to stop abusive lending.

Moreover, even if government entities would be able to bring a number of these types of cases, the damages provided for in the amendment are limited to one million dollars. Typical settlements against major predatory lenders are often greater by a multiple of 100 or more. Given the recent settlements in hundreds of millions of dollars by Attorneys General, the penalty proposed in the amendment is unlikely to serve as an effective deterrent against predatory lending.

We agree that encouraging federal enforcement is a worthy goal. In addition, establishing a fund to compensate victims as proposed by the pattern and practice amendment is a worthy objective. Similar funds have been negotiated in previous discrimination complaints brought by the Department of Justice. But encouraging federal enforcement via the pattern and practice amendment will not ensure that borrowers who have been harmed obtain a remedy, nor will it ensure that market players have an incentive to change their behavior.

We encourage the House Financial Services Committee to have annual hearings and Government Accountability Office (GAO) assessments about federal agency enforcement of the nation's consumer protection and civil rights laws. You have had these hearings in conjunction with examining HMDA data issues. The responses by the regulatory agencies to questions about lax enforcement have been disappointing to date. However, continued hearings of this nature will hopefully motivate the agencies to step up their enforcement activities. Specifically, we believe that the Committee should hold a comprehensive oversight hearing examining the lack of federal agency enforcement during the massive amounts of abusive lending of the last several years.

Loan Modification Amendment Counterproductive; Only Mandatory Loss Mitigation Will Result in Needed Loan Modifications

Another amendment, Representative Castle's H.R. 4178, or the Emergency Mortgage Loan Modification Act of 2007, is also well-intentioned but is not necessary to facilitate modifications and may actually enable abusive modifications. H.R. 4178 provides immunity from all liability for a creditor, assignee, servicer, or securitizer if the entity has enacted a qualified loan modification or workout plan. A blanket protection from liability in return for unspecified obligations is a risky exchange that leaves many borrowers vulnerable to superficial modifications that do not result in affordable loans. For example, the bill does not specify if the modification is to be permanent and does not establish parameters concerning the terms and conditions of the modification. As a result, temporary fixes with usurious fees could qualify a financial entity for immunity from liability.

An alternative approach to the Castle amendment is to require servicers to make reasonable efforts to engage in loss mitigation prior to foreclosure. Failure to engage in

reasonable loss mitigation efforts should be a defense to foreclosure. In addition, a significant barrier to loss mitigation efforts has been the fear of investor lawsuits. Accordingly, to the extent that immunity is necessary to foster loan modifications, it is immunity for servicers and other agents from investor lawsuits.

We agree with FDIC Chairman Sheila Bair that large scale automatic loan modifications are necessary to head off the foreclosure crisis. A sensible approach would involve a two-step process in which automatic loan modifications are offered to borrowers victimized by problematic lending and able to afford the loan modifications, followed by a variety of case-by-case measures. Automatic loan modifications would include conversion of adjustable rate mortgages to fixed rate loans at the teaser rate, or the fully indexed rate, whichever is lower; write downs of fixed rate loans to the par rate; and/or principal reductions to present market value. After exhaustion of this tier, case by case assistance would include a stay on foreclosure while the servicer does a good faith review of the borrower's long-term financial situation and offers a repayment plan, forbearance, loan modification or other option to bring the arrears current. Failure to engage in this process, as noted above, should be a defense to foreclosure.

Recent headlines and court decisions around the country have called into question servicer and holder conduct with respect to borrowers in default. In the interest of maximizing profits, some servicers have engaged in a laundry list of bad behavior and exacerbated foreclosure rates. The most common abuses in loan servicing include misapplication of payments, use of suspense accounts, failure to make timely escrow disbursements, and cascading fees imposed upon homeowners in default. These abuses exist because there are market incentives rather than deterrents for this type of behavior.⁷

For the same reasons, large-scale loan modifications present new opportunities for servicer abuse. The imbalance in information and knowledge between the consumer and financial institution often critiqued in the loan origination context is even worse in the loss mitigation process. The disclosure of information is entirely one-sided. The borrower is required to provide much of the same documentation related to their financial status as is required (or should have been required) at the origination stage. The servicer produces nothing except a "take-it-or-leave-it" agreement. Two problems that have already taken root are the charging of unreasonable fees and a requirement that the borrower waive any past or future claims. These practices need to be nipped in the bud and not allowed to flourish.

- Unreasonable or Unearned Fees – Compensating loan servicers for loan modifications may be critical to the success of the loan modification strategy. However, the amounts charged by the servicer, usually to the homeowner, should reflect a reasonable fee and actual costs, must be allowed under the terms of the note and security instrument, and

⁷ See Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good Business and Affordable Homeownership Policy": What Prevents Loan Modifications?*, 18 Housing Policy Debate 279 (2007).

should not violate state law.⁸ Additionally, fees assessed to the borrower should be reduced when another party is compensating the servicer for their work. Reduced fees or waiver of the fee should also be available. When a loan is undergoing modification because it was an abusive loan at inception, all fees should be paid by the lender and/or holder and none of the costs can be passed to the borrower. HR 3915 prohibits modification fees only for very high-cost loans exceeding the triggers established by the Homeownership and Equity Protection Act (HOEPA). This prohibition needs to be expanded to require waiver of fees in the cases of all problematic loans.

- Waiver of Rights – Often loan modification agreements contain a waiver of claims provision that purports to release the servicer and holder from any past or future claims that the borrower may have. For example, in a recently reviewed forbearance agreement, the borrower upon execution of the agreement released the “lender” from any claims or damages, including those that were unknown, including “tort claims, demands, actions and causes of action of any nature whatsoever arising under or relating to the Loan Documents or any of the transactions related thereto, prior to the date hereof, and borrowers waive application of California Civil Code Section 1542.”⁹ This broad release language potentially cuts off all claims the borrower may have related to the origination or servicing of the loan and is simply inappropriate in the context of a loan modification agreement.

Encouraging responsible behavior by releasing financial institutions from liability will ultimately backfire as some financial institutions will engage in the bare minimum or will establish fraudulent remedies in order to qualify for the immunity from liability. Such a “carrot” could facilitate a “cost of doing business” scenario in which financial institutions profit from abusive lending and then escape liability when they modify loans. It is possible that this carrot approach could result in minimal loan modification but maximum loss of rights for the borrowers victimized by abusive lending.

Instead, holding financial institutions accountable when they engage in unfair and deceptive practices is a common, accepted, and effective mechanism for rooting out abuse and encouraging responsible behavior. This principle applies to loan workouts and servicing just as it does to loan origination.

⁸ The Fannie Mae Single Family 2006 Servicing Guide allows servicers to charge the borrower \$500 to cover its administrative processing costs, plus the actual out-of-pocket expenses for a credit report and other documented expenses. See Fannie Mae Single Family 2006 Servicing Guide, Part VII, 502.02 (Modifying Conventional Mortgages)(9/30.05), available at <http://www.allregs.com/efnma/>. There is no limit on modification or workout fees charged by servicers on loans not covered by the Fannie Mae or Freddie Mac Servicing Guides.

⁹ Section 1542 of California’s Civil Code provides that: “A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if known by him must have materially affected his settlement with the debtor.”

Private Enforcement Critical to Protection of Consumer Interests

If the members of the House Financial Services Committee are contemplating boosting enforcement and remedies offered by HR 3915, we recommend that the committee allow individuals to pursue private actions for all loans. Currently, HR 3915 prohibits private action if the borrower has received a qualified mortgage and precludes most actions or remedies if the borrower received a qualified safe harbor mortgage. Moreover, a borrower with a loan outside the safe harbors has very limited remedies under the bill, including when a securitizer has engaged in due diligence but when the borrower's loan violates certain requirements (including ability to repay).

A significant shortcoming with this limited liability regime is that qualified mortgages and qualified safe harbor mortgages can still be abusive loans. A qualified mortgage can be a prime option Adjustable Rate Mortgage (ARM) that can leave a borrower in an unaffordable mortgage. A borrower can elect to pay a monthly amount that is even less than monthly interest payments, resulting in negative amortization. When the interest rate resets and/or non-amortizing payments are no longer permitted, the borrower confronts significant payment shock and is likely to become delinquent and/or default.

A qualified safe harbor mortgage can also be problematic. A subprime mortgage is a qualified safe harbor mortgage if it meets the following conditions:

- 1) the annual percentage rate is three percentage points higher than Treasury securities of comparable maturity,
- 2) the borrower's income is verified and documented,
- 3) the loan is underwritten at the fully-indexed rate and the underwriting considers monthly payments for principal, interest, taxes and insurance,
- 4) the loan is not a negative amortization loan,
- 5) the loan meets any additional characteristics proscribed by regulation,

And any of the following one factors:

- 6) the monthly payment is fixed for five years,
- 7) for adjustable rate loans, the APR is not in excess of three percentage rates of any commonly used index rate,
- 8) the loan's debt-to-income ratio does not exceed a threshold level determined via regulatory rule-making.

The criteria associated with a qualified safe harbor mortgage do not guarantee that the loan is not abusive. For example, a loan could meet all of the criteria including a debt-to-income ratio lower than the threshold specified by the regulatory agencies. In this example, it is assumed that the regulatory agencies established a debt-to-income ratio of 50 percent, which is a ratio commonly used in legislation and is an industry standard. The loan may have a debt-to-income ratio of 49 percent, but the borrower's income left over to pay for other necessities such as food and transportation is insufficient. Since the criteria do not require an analysis of residual income (the income left over to pay for other basic necessities), it is quite conceivable that a qualified safe harbor mortgage can leave a borrower scrimping and scrapping, and unable to make monthly payments should a sudden increase in other costs such as utility payments occurs.

Another difficulty with the criteria of the qualified safe harbor mortgage is that only one of a subset of three criteria needs to be met. In other words, a qualified safe harbor can either have the monthly payment fixed, or be an ARM loan with an APR within three percentage points of an index rate, or have a debt-to-income ratio that does not exceed a specified ratio. A series of scenarios are conceivable in which a loan meets one or two of these criteria but is unaffordable because it does not meet the other criteria. For example, suppose a loan meets the fixed payment and debt-to-income criteria, but is unaffordable because it has a very high APR that is several percentage points above a commonly used index rate. Yet, a borrower would not have a private right of action to remedy this unaffordable loan.

Eliminating private rights of action for individual borrowers for broad categories of loans is a guaranteed formula for offering insufficient borrower protections. As demonstrated above, the established criteria can qualify loans as safe for borrowers when in fact the loans are abusive. Furthermore, the lending industry is innovative and can create loans in the future that the drafters of the legislation, or any of us, could not imagine and safeguard against in a safe harbor. While some criteria may appear to protect against abuses considering today's loan products, the same criteria will be insufficient to protect against future loan products with terms and conditions that defy today's conventions.

Still another problem with the limited liability regime in HR 3915 is that a securitizer could purchase significant numbers of abusive loans that are not qualified mortgages or qualified safe harbor mortgages. HR 3915 requires a securitizer to establish due diligence procedures that weed out mortgages that are not qualified mortgages or qualified safe harbor mortgages. A securitizer in today's market is likely to be processing tens of thousands or hundreds of thousands of mortgages. Even a robust due diligence procedure is likely to miss catching significant numbers of mortgages that are abusive and are not qualified mortgages and qualified safe harbor mortgages. In addition, due diligence procedures may not be adequate. HR 3915 requires the federal agencies to develop regulations proscribing due diligence procedures. There is no guarantee that these regulations will require rigorous due diligence procedures. In addition, the bill's formulation allows a securitizer to skip the due diligence altogether and simply cure the loans for the limited number of borrowers who come seeking a cure.

One of the amendments offered by Representative Watt on the House floor but that did not garner sufficient support would have allowed a securitizer or assignee to escape liability only if the securitizer offered a borrower a cure and the secondary market agent had policies and procedures in place to not purchase non-qualified or non-qualified safe harbor mortgages. This amendment would have at least allowed all individual borrowers who were victimized to achieve remedies *and* would require due diligence by securitizers.

In the absence of an effective individual right of action, HR 3915 is creating a regime that is arguably worse than mandatory arbitration. While disallowing the right to go to court, mandatory arbitration establishes a procedure under which a borrower can seek redress, which is often inadequate and marred by a one-sided procedure that favors the industry repeat-players. Under HR 3915, it is very conceivable that a borrower could be suffering due to a predatory loan, but have absolutely no means to seek redress.

If the House revisits HR 3915 in conference or under other circumstances, we encourage consideration of private right of action by borrowers and direct remedies for borrowers. This would be the best incentive for the industry to alter abusive practices.

Conclusion

We commend the Chairman and the ranking member of the House Financial Services Committee for holding this hearing to consider amendments to HR 3915. The federal enforcement of pattern and practice and the loan modification amendments are well meaning proposals to fix shortcomings with HR 3195. But for the reasons elaborated upon above, they will not solve the fundamental problem of a lack of accountability in the lending marketplace. Currently, the interests of the borrower, the loan originator, and all other actors through to the investor are not aligned. The misalignment of interests has created a dysfunctional market that engages in dangerous lending in order to maximize profits without consideration of the borrower's interest. Only when the financial institutions are accountable to the borrower for basic principles of fairness, affordability, and sustainability are the interests of all aligned. And ultimately, the only way to hold financial institutions accountable to the borrower is to make financial institutions liable to the borrower for remedying abusive loans.

Thank you for this opportunity to testify on this important matter