NATIONAL
CONSUMER LAW
CENTER INC

Washington Office:
1001 Connecticut Avenue, NW, Suite 510
Washington, DC 20036
Phone: (202) 452-6252
Fax: (202) 463-9462
Boston Office:
7 Winthrop Square, 4th Fl.
Boston, MA 02110-1245
Phone: (617) 542-8010
Fax: (617) 542-8028
consumerlaw@nclc.org
www.ConsumerLaw.org

Mortgage Reform:
Immediate Steps to Address the Foreclosure Crisis and
Modernize Home Mortgages for the Twenty First Century

I. INTRODUCTION

Deregulation of mortgage credit has proven an unmitigated disaster. The laws governing mortgage credit must be changed. Without significant changes in the rules of the game, the lending industry will continue to play Russian roulette with the financial health of working families, neighborhoods, and ultimately our entire economy, with inevitably tragic results.

We must immediately and effectively address the foreclosure crisis:

A. Permit bankruptcy judges to modify loan terms for home mortgages, as they may for other debts;
B. Implement a foreclosure moratorium and require mass restructuring of loans;
C. Mandate loss mitigation before a foreclosure is commenced; and
D. Remove the adverse tax consequences for homeowners of loan modifications.

We must prevent a recurrence of this financial collapse by modernizing the mortgage market:

A. Originators Must Have a Reasonable, Documented Expectation that Mortgage Loans Can Be Repaid on Their Stated Terms.
B. Standard, Uniform Mortgage Products Should be the Norm.
C. Purchase or Refinance Mortgage Loans Made Above Home Value Should Be Eliminated.
D. The Tax Code Should Not Encourage Home Equity Spending.
E. Assignees Should Be Subject to Full Credit Risk.
F. Servicers Must Be Made Responsible and Responsive to Homeowners.
G. Usury Ceilings Should Be Re-Imposed.
H. Loan Origination and Servicing Should be Subject to Standards for Unfair, Deceptive and Unconscionable Conduct.
I. Federal Law Must Only Preempt Weaker State Laws.
J. State Supervisors, and Public and Private Attorneys General Must Be Given Full Enforcement Authority of Federal Mortgage Regulation.

II. IMMEDIATE STEPS TO ADDRESS FORECLOSURE CRISIS

We have been in a foreclosure crisis for well over a year, yet no meaningful steps have been taken to halt foreclosures. The continuing pace of foreclosures erodes the benefits of any other steps taken. Current measures are ineffective:

- Servicers are both unable and unwilling to undertake sustainable loan modifications on a sufficiently large scale, due to systemic barriers. Programs such as the Hope Now Hotline have failed to slow foreclosures or even provide meaningful relief for a significant number of individual homeowners.
- Hope for Homeowners has been all but ignored by the servicing industry. Even if fully implemented, it may provide relief for only 400,000 families—less than 2% of the foreclosures projected to occur by 2009.
- The new streamlined modification programs for GSE loans do not reach subprime loans, which continue to drive the foreclosure crisis.
- To date, TARP has not been used to promote, let alone mandate, a single loan modification.

Congress must ensure that fair and affordable loan modifications are offered where appropriate, in all segments of the market, regardless of who originated, serviced, or purchased the loan.

A. Congress Should Amend the Bankruptcy Code to Give Bankruptcy Courts the Power to Modify Home Mortgage Loans

Proposal: Permit bankruptcy judges to modify home loans.

Background: This is an efficient means for saving homes with no cost to the taxpayers. Judicial oversight—and the stigma and cost of bankruptcy—guard against concerns that this is a no-cost option for homeowners. Bankruptcy already is used to modify almost every other kind of secured and unsecured debt.

B. Congress Should Pass an Immediate Foreclosure Moratorium and Require the Mass Restructuring of Loans.

Proposal: A moratorium is necessary to give Congress breathing space to begin to address the systemic barriers to mass restructuring of loans. Several models have been proposed.[1]
Moreover, under the Troubled Assets Relief Program (TARP), Treasury should: develop a loan modification program that can be routinized and applied on a large-scale basis; condition any purchase of an equity interest in a financial institution on a rigorous loan modification plan; provide guarantees only for *affordable* loan modifications; and purchase a sufficient stake in assets to enable the implementation of an aggressive modification program through the purchase of whole loans, second mortgages, securities, or servicing rights.

---

[1] For a discussion of possible models to address the mass restructuring of loans, see, for example, Michael Barr & James A. Feldman, *Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages,* Center for American Progress (Apr. 22, 2008), *available at* http://www.americanprogress.org/issues/2008/04/reimc_brief.html; Robert Kuttner, *It's Time to Save the Housing Sector*, Boston Globe (January 24, 2008), available at http://www.boston.com/realestate/news/articles/2008/01/24/its_time_to_save_the_housing_sector/ (discussing the Home Owners Loan Corporation of the New Deal era).

Background: Voluntary measures are not providing permanent solutions to unaffordable loans and redefault rates are high. Because the foreclosure crisis is at the root of the current economic meltdown, it needs to be addressed directly with a program that can ensure affordable, sustainable loan modifications. While the public discourse has lately included extensive discussion of whether some homeowners really "deserve" help, this red herring should be ignored, just as it has been when Treasury infused capital into banks and other financial institutions. Our society must help homeowners now just as it did in the 1930s and assure that the mortgage loans they repay are affordable and sustainable, something the banks and subprime lenders failed to do when they originated the troubled mortgages. Avoiding foreclosures assists not only the homeowners, but also their children, their neighbors, their communities and their cities. Moreover, loan modifications return more to the investors than foreclosures.

C. Congress Should Require Meaningful Loss Mitigation Prior to Foreclosure

Proposal: Require meaningful loss mitigation prior to a foreclosure. H.R. 5679 would align mortgage servicer incentives with those of both the homeowner seeking to prevent a foreclosure and the investors seeking to minimize losses by requiring reasonable loss mitigation and by prioritizing "home-saving" measures over those that result in loss of the home. The bill also would reform servicing practices to mandate borrower access to a decision maker and require information and dispute resolution prior to foreclosure.

Background: As there are neither requirements nor incentives encouraging servicers to help homeowners avoid foreclosure, generally servicers do little to help. The FDIC "Loan Mod in a Box" program establishes a framework for loan modifications that ensures that loan modifications are designed that are financially beneficial to investors. In the long run, homeowners, their communities, and mortgage investors all will benefit from a system that encourages housing sustainability.

D. Congress Should Ensure That Loan Modifications Do Not Give Rise to Taxable Income.

Proposal: Loan modifications when the homeowner is near default should not give rise to taxable income and should be excluded both from taxable income and from all reporting requirements.

Background: Principal reductions, or, in some cases, significant interest rate reductions, can lead to imputed taxable income to the homeowner. This may happen even if, as under Hope for Homeowners, the homeowner may have a future obligation to repay some of the forgiven debt. The Mortgage Debt Forgiveness Relief Act of 2007[2] fails to solve this problem. The Act is inadequate for a variety of reasons; most significantly, the Act only applies to the amount of acquisition debt forgiven, and a majority of the troubled subprime loans refinanced acquisition loans.

III. *MODERNIZING HOME MORTGAGES FOR THE 21ST CENTURY*

A. Originators Must Have a Reasonable, Documented Expectation that Mortgage Loans Can Be Repaid on Their Stated Terms.

Proposal: Many of the mortgages made in recent years could only have been repaid by refinancing. When housing values plummeted, and credit tightened, the lenders' failure to ensure that

---

2 Pub. L. No. 110-142.

homeowners could afford their mortgages became apparent. The complexities of the mortgage terms often meant that only the lender understood the potential increase in payments. *This failure to determine affordability is the single most important factor in the current mortgage crisis.* Only if all of the following components are required will both homeowners and investors have assurance that loans are capable of performing as advertised:

- All payments due under the terms of the loan, after allowing for all permitted principal and interest rate increases, must be affordable.
- Analysis of payment affordability must include property insurance and taxes.
- All income must be verified independently, using wage statements, bank account and deposit records, tax information or other third-party information, as available and appropriate.
- Analysis of affordability must include both a permissible range of debt-to-income ratios and a threshold limit of residual income.

Background: The two federal laws that regulate mortgages–the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA)–focus on disclosure, presuming that this will sufficiently help consumers operate in the marketplace. The 1995 Home Ownership and Equity Protection Act (HOEPA) amendment to TILA placed limits only on the highest cost loans, leaving the rest of the market unaddressed. While the rulemaking by the Federal Reserve Board in 2008 increases affordability requirements for a portion of the market, it nevertheless permits unaffordable loans to continue by not covering a substantial share of the market and by not ensuring that holders of unaffordable loans remain responsible for the problems.

In the current mortgage origination process, the originator sells each individual mortgage loan to a trust that securitizes it with thousands of others for sale to corporate investors. The originator suffers little risk if the loan payments are not made on the loan—as the originator has recovered its profit long before the first payment is due. The securitizer has little risk—it has recovered its cost and profit once the investors purchase shares of the trust. The corporate investors do stand to lose money—but only if a plurality of the loans within the trust fail, not if any one fails. The current system protects the industry players against loss as long as the housing market is stable, even when loans are not affordable to the homeowners. This dynamic means the homeowners need to be specifically protected with requirements that assure that loans will be affordable.

B. Standard, Uniform Mortgage Products Should be the Norm.

Proposal: Originators should be required to offer every mortgage loan applicant a fixed rate, fully amortizing 30-year mortgage. These products are well understood by both lenders and consumers, perform in a predictable manner, and permit homeowners to choose between competing products. Only government fees and taxes would be permitted outside the interest rate, resulting in lenders putting all of the costs of originating the loans into the rate, and limiting the profitability of the origination process (in contrast with profit from the stream of payments following origination). Prepayment penalties also should be banned. Narrowly drawn exceptions to the requirement of a standard mortgage offer could be drafted by an independent federal agency tasked with protecting homeowners in the mortgage marketplace.

Background: Federal law should promote transparency and fairness. The extension of consumer credit should be a fairly simple transaction that is easy for all parties to understand. The costs and risks of the transaction should be transparent and intuitive. The non-traditional mortgage products that led to the collapse of the market are exceedingly complex, with hidden costs, contingencies, and risks that are impossible for even sophisticated consumers to understand. Even if consumers shop, they are choosing among products about which they have little comprehension and less control.

Industry providers will continue to have greater bargaining power in the transaction, as well as better access to essential information about the meaning of and the risk of various loan terms. While innovation of products and procedures should be fostered, the playing field must be leveled to provide consumers with a fair marketplace.

C. Purchase or Refinance Mortgage Loans Made Above Home Value Should Be Eliminated.

Proposal: Home loans should not be made for more than the home value. Originators and underwriters must be held accountable for the quality of the appraisals used to justify their loans.

Background: Loans beyond the home value trap families in place. An underwater home can neither be sold nor refinanced. In the current predatory loan crisis, many homeowners have been trapped in loans that exceeded the value of their home at the time loan origination due to an inflated appraisal, even before the real estate market declined. Originators, underwriters, and investment houses connived or condoned inflated appraisals, expecting to recover the full amount of an inflated loan through a subsequent refinance. This pyramid scheme worked only so long as housing values continued to rise. When the value of homes decreased, the whole arrangement collapsed. Investors and homeowners need to be protected in the future.

D. Assignees Should Be Subject to Full Credit Risk.

Proposal: Any party who holds the mortgage note should be fully liable, up to the value of the original note, for all claims and defenses relating to the origination of the loan. Moreover, assignees should be clearly liable for claims against servicers that arose before or during the assignee's period of ownership.

Background: The demands of the secondary market have dictated the characteristics of the mortgages originated. Unless and until the secondary market bears some risk for dangerous origination practices, beyond the risk of default, illegal origination practices will continue to be tolerated in the marketplace. The relief that homeowners need—offset against the note—only is meaningful if it is available from the current holder of the note. Assignee liability for claims against the servicer would align the interests of the secondary market with those of homeowners in seeing loans fairly originated, fairly serviced, and performing as promised. Wall Street currently bases its risk assessments upon potential and ascertainable losses. Limited assignee liability is entirely consistent with current practice.

E. Servicers Must Be Made Responsible and Responsive to Homeowners.

Proposal: Servicers need incentives to respond to the needs of homeowners and to assist in avoiding foreclosure. Servicers' incentives should be clearly defined to include a fiduciary duty to the homeowners.

Background: Servicers currently have little incentive to provide assistance to homeowners. Servicers are hired and have specific agreements with the secondary market (the Pooling and Servicing Agreements) that outline only their obligations to the investors. Servicers make money from homeowner defaults, and currently are better remunerated for foreclosures than for loan modifications.

F. Usury Ceilings Should Be Re-Imposed.

Proposal: Loan charges, including interest and fees, should be limited to a reasonable range above the cost of money. Loan fees (charged at origination, during the course of the loan term, and in the case of foreclosure) also should be strictly limited. Risk-based pricing should be allowed only within that narrow range and the basic structure of the mortgage product should be premised on the expectation that repayment will occur. All charges, including interest, closing costs, and mortgage insurance, should be included in caps on interest rates.

Background: The primary purpose of state law usury statutes on mortgage loans—preempted in 1980—was to ensure that consumers could repay the debt. Usury statutes mandated affordability in two ways. *First*, as there were strict limits on the amount of interest that could be charged for each loan, the profits from each loan were limited, which meant that every loan had to be self-sustaining. If a creditor could not make a large profit on any particular loan, the creditor could not afford many losses from other, unpaid loans. This made the creditor careful to ensure that each borrower could afford to make payments required by the loan. *Second*, as there were limits on the amount of money a creditor could charge when the loan was first originated, the *only* way the lender recouped the principal of the loan and made a profit was from the stream of loan payments by the borrower.

Higher fees and higher rates paradoxically promote the very risk of default for which they allegedly compensate lenders. Returning usury statutes to their full effectiveness would significantly encourage performing home loans.

G. Loan Origination and Servicing Should be Subject to Standards For Unfair, Deceptive and Unconscionable Conduct

Proposal: Federal law should clearly proscribe all unfair, unconscionable, or deceptive acts and practices in loan origination, servicing, and investment.

Background: Both the Guidance issued by the federal banking regulators in 2006 and 2007 as well as the loan prohibitions promulgated by the Federal Reserve Board in 2008 address some of the worst abuses. Both suffer from serious flaws. The Guidances are voluntary and do not apply to all actors in the market (much of the secondary market, for example, operates outside the reach of either the federal or state banking regulators). The regulations issued by the Board cover more actors, but largely do not apply to the prime market and have other loopholes that permit creditors and investors to game the system. Neither the Guidances nor the regulations have sufficient enforcement mechanisms to ensure real compliance.

H. Federal Law Must Only Preempt Weaker State Laws.

Proposal: States must be able to provide stronger consumer protections than federal law provides.

Background: Both the dual banking system and the most effective federal consumer regulation—HOEPA—have long relied on the federal law as a floor rather than a ceiling. This allows state legislatures and attorney generals, which are more nimble in responding to local crises, to adapt to changing conditions, while preventing a race to the bottom in banking regulation.

In the past ten years, many states have attempted to stop predatory lending, through either new statutes or stepped-up enforcement of existing statutes. Aggressive preemption of state laws and state action by the federal banking supervisors significantly hindered state efforts to restrain predatory lending. Moreover, the extent of the exemptions granted by the federal agencies remains a moving target and a constant source of confusion, debate, and litigation.

I. State Supervisors, and Public and Private Attorneys General Must Be Given Full Enforcement Authority of Federal Mortgage Regulation.

Proposal: In order to maximize compliance, supervisors and enforcement agencies at every level of state and federal government must have co-extensive authority to investigate and pursue violations of federal mortgage regulation. Consumers also play a pivotal role in the success of any regulation of the marketplace by complementing public enforcement efforts through a private right of action. Additionally, since the recovery for any individual homeowner is small and mortgage cases are complex and can last years, the law must provide for homeowners to recover their attorneys' fees and costs when they prevail.

Background: As demonstrated by the scale of the market collapse, no single agency or even several combined agencies have sufficient resources to adequately monitor every aspect of the mortgage market.

J. The Tax Code Should Not Encourage Home Equity Spending.

Proposal: The changes to the Tax Code in 1986 that eliminated deductions for personal debt while expanding deductions for home equity debt should be rolled back.

Background: Homeowners have difficulty evaluating the price and risks of long term debt. Consolidation of non-mortgage debt actually costs thousands more dollars because of the extended repayment term, even after counting the tax benefits. The consequences of paying non-home expenses with home equity is not only expensive, it encourages the depletion of the primary way for low to moderate income families to build wealth, plan for retirement, and sustain communities. The federal tax code should have incentives that encourage sustainable home loans. Current tax law, only permitting tax deductions for home secured debt, increases the risk of foreclosure.