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Testimony before
U.S. House of Representatives
Subcommittee on Housing and Community Opportunity
Subcommittee on Financial Institutions and Consumer Credit

Hearing on Legislative Solutions to Abusive Mortgage Lending Practices
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I would like to thank Chairman Ney and Chairman Bachus for the opportunity to testify today at this important hearing on predatory lending. I am Micah S. Green, president of The Bond Market Association, which represents securities firms and banks that underwrite and trade fixed-income securities both domestically and internationally. I am also representing today the views of the American Securitization Forum (ASF), an adjunct forum of The Bond Market Association, which is a broadly-based professional forum of participants in the U.S. securitization market. Among other roles, ASF members act as investors, issuers, underwriters, dealers, rating agencies, insurers, trustees, servicers and professional advisors working on transactions involving securitizations of residential mortgages and other types of financial assets.

The secondary market for mortgage debt—the segment of the financial industry that purchases and repackages loans as mortgage-backed securities or MBS—witnessed tremendous growth over the past decade. At present, there are about $5.6 trillion in mortgage-related bonds outstanding, or nearly a quarter of all fixed-income securities. Such significant participation by the capital markets in the mortgage lending business benefits consumers in the form of lower interest rates and more widely available credit. No doubt there are thousands, if not millions, of families who were able to find mortgage financing and purchase a home on more affordable terms because of the secondary market. The growth in the secondary mortgage market overall has led to a much greater availability of credit for subprime borrowers, or home-buying families who, because of credit problems, traditionally have had less access to the mortgage market.

As the volume of subprime loans has grown, however, demonstrated cases in which lenders followed abusive practices have surfaced. There is no question that abusive loan terms and lending practices—commonly known as "predatory lending"—are bad and should be stopped. The Bond Market Association and the American Securitization Forum acknowledge this reality and the role the secondary market can play in addressing this problem. We have worked with lawmakers and regulators at the state and local level

as well as Congress and other federal policymakers for the past five years to promote sensible anti-predatory lending policies.

Thanks to the determined efforts of Chairman Ney and Rep. Kanjorski, we now have legislation, the Responsible Lending Act (H.R. 1295), that addresses the problem of predatory lending in a balanced way. Chairman Ney and Rep. Kanjorski have taken special care to reach out to all stakeholders in the debate over predatory lending. As a result, they have crafted an informed and effective bill which we support.

The Responsible Lending Act deals with the problems that arise from dozens of sometimes vague and conflicting state and local laws by creating a uniform national standard for the terms under which high-cost loans are made. Critically important, these terms are objective and measurable. Under this legislation, borrowers facing foreclosure could bring defensive claims against loan assignees under certain circumstances. Assignees could also be the subject of affirmative claims, or those brought outside of the context of defending against a specific foreclosure claim, unless they could prove that a reasonable level of loan review would not have revealed the lending violation in question. By observing an objective standard for loan review that could reasonably be expected to screen loans with potential predatory lending problems, secondary market participants can avoid potential liability. The Responsible Lending Act also provides loan purchasers with a "right to cure", or the opportunity to amend a loan and compensate the borrower when they identify loans made in violation of the terms set out in the bill. All claims would be limited to actual damages unless a borrower can prove reckless indifference on the part of the assignee.

The Need for Federal Pre-emption

Federal regulators' primary weapon against predatory lending is a 1994 amendment to the Truth in Lending Act that became known as HOEPA, for the Home Ownership and Equity Protection Act. The law created the concept of a high-cost loan as one with an annual percentage rate or fees that exceed a specified threshold. The Federal Reserve Board (Fed) has the authority to adjust the benchmarks. The Fed also promulgates the regulations to implement the law.

Certain features of loans designated as high-cost by HOEPA are restricted. These include prepayment penalties and negative amortization, among others. HOEPA also advanced the idea of assignee liability, or the notion that purchasers of mortgage loans could be held liable for the actions of mortgage originators. As discussed in the next section, HOEPA subjects loan purchasers to the claims and defenses a borrower could bring against the originating lender. The law initially only applied to about 5 percent of the subprime mortgage market. Following a Federal Reserve Board decision to lower the threshold interest rates in 2001, HOEPA's reach has grown but still only extends to a limited market segment. Because of its relatively limited applicability, HOEPA has not proven to have significantly limited the availability of subprime mortgage loans.

In recent years, however, several states and localities have built on HOEPA's general approach with new anti-predatory lending laws to the point that much more of the subprime market is now affected. Loans are categorized as high-cost—some laws refer to such loans as "covered"—if the annual percentage rate or fees associated with the loans exceed a given threshold. At least 47 varying state and local laws regulate subprime lenders in addition to HOEPA.

It is not only the terms of the different state and local laws, but also the volume of varying and often conflicting standards that impose unreasonable burdens on the secondary market. Maintaining the expertise needed to comply with varied statutes in an array of jurisdictions adds unnecessary levels of complexity cost and risk to the subprime securitization process. Several provisions in the different state and local laws require careful legal judgments that cost time and money. Every legal question also carries with it an added element of risk. More importantly, whether a given loan may be regarded as "predatory" under various state and local laws often requires subjective judgments and knowledge of facts that are beyond the reach of secondary market purchasers and assignees. In these circumstances, no amount of loan review or investigation performed by secondary market purchasers can determine the presence or absence of lending violations, thus presenting economic, reputational and other risks that cannot be managed. The choice presented in these cases is either to accept unmanageable risks or to avoid acquisition of covered loans altogether. Not surprisingly, many potential secondary market purchasers have been forced as a matter of business necessity to choose the latter option, thus depriving the mortgage origination market of new capital and limiting the availability of mortgage loans to families with subprime credit.

Ultimately, any increase in cost, risk and complexity in secondary market operations leads to higher costs for borrowers. Loan purchasers will demand higher yielding loans—if they choose to purchase high-cost loans at all—when faced with the uncertain legal environment that exists today with the patchwork of state and local anti-predatory lending laws. Loan originators, in turn, will simply charge borrowers higher rates and fees—if they continue to originate high-cost loans at all.

By preempting state and local laws and replacing them with a uniform and balanced standard, the Responsible Lending Act eliminates the conflicts and inefficiencies that result from the varying state and local anti-predatory lending standards. Besides lowering the cost of credit, securitization has expanded its availability and helped develop a truly national mortgage market. It follows that a national legal standard should govern this market, which the Responsible Lending Act achieves.

Assignee Liability

Developing an effective assignee liability standard—one that punishes bad actors without exposing innocent loan purchasers to a level of unmanageable risk that drives them from

the market—is also hampered by the patchwork of state and locals laws. The different state and local laws sometimes use subjective triggers to assign liability to the loan purchasers.

Currently, civil actions brought against lenders for infractions of HOEPA may also be brought against an assignee of the lender if the violation is "apparent on the face of the loan document."[1] An assignee or the purchaser of a mortgage will not be subject to the claims and defenses of the borrower if a "reasonable person exercising ordinary due diligence, could not determine" the mortgage was a high-cost loan under HOEPA .[2] Unfortunately, neither this standard nor subsequent court decisions have effectively settled the question of what "apparent on the face" means in practice. Recent state laws have compounded this problem by creating still more standards for assignee liability.

It is important to note the presence of loans originated using predatory practices in the pools of loans backing mortgage securities is not in anyone's best interest. Not only do predatory lenders target individuals with risky credit profiles, but the terms of predatory loans often promote default. The more defaults experienced by the pool backing an MBS issue, the less attractive the security becomes to investors who ultimately bear this risk. In order to maintain investor support and capital market liquidity to fund continuing operations, securitizers of mortgages—which include mortgage originators as well as financial institutions that purchase and package mortgage loans in the secondary market—have a clear incentive to eliminate from pools any loans they can identify that violate applicable predatory lending laws. In order to do this efficiently, however, the lending standards must be clear and objective, and this is not always the case.

The different state and local laws sometimes use subjective triggers to assign liability to the loan purchasers. An Illinois state law, for example, makes the purchaser of a loan liable if the loan originator was found to have used "deceptive practices"—a pattern of behavior that cannot be detected in a review of a standard loan file. Laws such as this create legal circumstances inconsistent with the notion of fundamental fairness. A loan purchaser should not face liability for lender actions in which it did not participate, cannot observe, and that cannot be detected in a review of the loan file.

A New York City law that was struck down by the courts would have required an arbitrary level of due diligence on loan pools in order to escape liability for subprime lending violations. Complying with the level of due diligence set by this statute would significantly raise the cost of purchasing covered mortgages, which would increase borrower costs. In many cases, the screening prescribed by the New York City law would have been impossible. Assignees cannot know whether or not certain subjective loan origination standards were met. The purchaser does not have unique insight into what type of loan or specific loan features are suitable for that borrower. Assignee liability under such circumstances is unreasonable. Assignees would have neither the

[1] 15 U.S.C. 1641(a)
[2] 15 U.S.C. 1641(d) 1

opportunity to identify violations in advance of purchasing the loans, nor the ability to mitigate legal exposure once they do identify violations.

Using anything but a single set of objective and readily detectable standards to determine whether an assignee has liability is a regulatory approach that threatens to undermine many of the benefits of the secondary market. Faced with this type of environment, secondary market participants may find it less attractive to purchase and repackage subprime loans.

The Responsible Lending Act sets out a definition of "higher cost" loans. The bill then goes on to define in clear language the terms and restrictions placed on such loans. As a result of these clear and objective standards, assignees employing the normal practice of loan review can have confidence they will be able to effectively screen for loans containing lending violations.

H.R. 1295 properly restricts the claims that can be brought against assignees to those available under HOEPA as amended by the bill. To do otherwise would be impractical. Assignees can effectively screen pools of loans for compliance with a known set of standards, such as the loan terms in the Responsible Lending Act. Exposing assignees to every conceivable law that could give rise to a claim, however, is not practical.

The Responsible Lending Act describes two types of claims: defensive and affirmative. A borrower's right to bring such claims is based on certain factors not present in current law. The right to bring a defensive claim against an assignee is limited in the first instance to situations where the default is reasonably related to a violation of the lending terms prescribed by H.R. 1295. The point of this provision is to protect against loans with predatory lending violations that cause harm. If there is no connection between a borrower's default and the originating lender's violation of the anti-predatory lending laws, the balance of legitimate interests weighs in favor of the innocent assignee who, pursuant to existing legal doctrine, must have acted in good faith and without actual knowledge of a lending violation. If such a nexus exists, however, the balance of interest weighs in favor of protecting the borrower. The important exception to this rule is the case where the assignee is not innocent. H.R. 1295 provides that a borrower may bring a defensive claim against an assignee that had actual knowledge of the originator's violation or displayed a "reckless indifference" to a violation of the lending terms of H.R. 1295. This provision recognizes that despite a well-structured law, bad actors will always exist and should be held accountable.

Affirmative claims—those outside of the context of an enforcement of loan terms that are reasonably related to a borrower's default—can be brought in the case when an assignee cannot demonstrate that a reasonable level of loan review could not have detected the loan violation. In addition, the legislation provides a safe harbor from liability for assignees who meet clearly articulated criteria. This mechanism serves to benefit both assignees—by clarifying the instances in which they face liability—and borrowers—by

screening bad loans from the secondary market. The safe harbor is contingent upon the existence of policies that prohibit higher cost mortgages that contain lending violations, a contract with loan sellers stating they would not sell loans that contain violations and employ "reasonable due diligence" to prevent the purchase of loans with violations. Consistent with longstanding industry custom and practice, reasonable due diligence could be achieved by reviewing a statistically significant sample of loans and not necessarily reviewing 100 percent of loans.

Reasonable Damages and a Right to Cure

As noted above, the goal of the Responsible Lending Act is to protect borrowers against harm caused by predatory lending practices. This does not mean predatory lending victims are due an economic windfall. As with most laws, H.R. 1295 would protect the borrower against harm caused by a legal violation. What is eliminated under the Responsible Lending Act is the right to receive statutory damages from an innocent assignee. The borrower does not lose any right to bring a lawsuit against the lender that violates the law and can be made whole by an assignee under the appropriate circumstances.

Statutory damages, like punitive damages, are not compensatory in nature. They are designed to deter bad conduct by creating an economic disincentive to engage in illegal conduct. The Responsible Lending Act appropriately applies this policy with consideration for loan purchasers that did not know of or participate in lender violations by imposing liability for actual damages only. Exposing innocent assignees to liability for damages in addition to actual economic loss is more likely to discourage the purchase of higher-cost loans altogether, not just loans with lending violations.

To take an example, consider a borrower who incurs a debt of $100,000, the proceeds of which are used to pay off a below-market rate affordable housing loan of $75,000, a tax lien on the property of $5,000, a credit card debt of $12,000, and closing costs of $8,000. Even if the loan violates anti-predatory lending laws, the borrower did gain the ability to discharge various forms of debt. If a consumer receives a $100,000 loan, the original principal balance is still worth $100,000. Even if the upfront cost to acquire the debt or the interest rate on the debt is excessive, the value of the original principal amount of the debt does not change. Barring reckless indifference on the part of the assignee, the harm to the consumer could be mitigated by amending the relevant loan terms and providing compensation for actual economic loss. Awarding damages that exceed actual harm to the consumer would effectively extinguish some or all of the underlying principal balance. This would not be appropriate considering the borrower has already derived benefit from the transaction.

Nevertheless, HOEPA has built-in punitive damages or penalties, disguised as statutory damages, entitling a consumer to the amount of finance charges paid by the consumer. It compels a judge to award the enumerated damages irrespective of actual loss or actual harm by or to the consumer and without regard to a lender's intent to violate the law or its

good faith efforts to comply with a state's subjective prohibitions. The result of this pyramiding of penalties under the pretext of statutory damages can be the effective extinguishment of the debt, but not an extinguishment of the real economic benefits received by the borrower. By limiting damages, except in the instance where a borrower can prove reckless indifference on the part of the assignee, H.R. 1295 responsibly limits damages to actual economic losses.

The Responsible Lending Act would also permit an assignee to correct an error within 60 days of discovery. One way to cure would be to amend the loan to delete the offending terms. Given that the objective of H.R. 1295 is to protect the borrower against abusive loan terms, this makes sense. It also saves the borrower the cost of a legal claim. Reducing the interest rate or simply refunding excessive points and fees on a loan so the loan falls below the triggering point for higher cost, restores the borrower to the same economic position they would have held absent a violation. If one purpose of the assignee liability provisions is to reduce the number of loans with lending violations, then a reasonable way to accomplish that objective is to permit assignees to cure the violations to compensate borrowers for actual harm incurred. Once again, the public policy question is whether the law should be designed to protect the borrower against harm, not to penalize an innocent assignee which by definition did nothing wrong other than unknowingly buy a loan that violated applicable law.

Conclusion

By pre-empting varied state and local laws with a common-sense federal statute, the Responsible Lending Act promises to help preserve the benefits of securitization for subprime mortgage borrowers. Securitization has effectively nationalized the mortgage market assuring that credit is available to homebuyers regardless of where they live. The patchwork collection of standards confronting loan purchasers from dozens of state and local anti-predatory lending laws threatens the ability of subprime borrowers to realize the full benefit of the modern mortgage markets.

The Responsible Lending Act seeks to protect borrowers by providing for reasonable assignee liability when a foreclosure or other problems can be linked to what is considered an abusive lending term. In the case where an assignee shows reckless indifference for lending violations or fails to comply with a regulatory safe harbor, the borrower can bring a claim regardless of whether they face foreclosure. Because the goal of the Responsible Lending Act is to protect borrowers, not to provide them with an economic windfall, damages that can be awarded in relation to such claims are generally limited to actual economic loss.

The Bond Market Association and the American Securitization Forum have been pleased to work with Chairman Ney and Rep. Kanjorski on this important legislation and our members look forward to continuing the dialogue as H.R. 1295 advances in the legislative process.