TESTIMONY OF ASSISTANT ATTORNEY GENERAL PAMELA KOGUT
OFFICE OF MASSACHUSETTS ATTORNEY GENERAL THOMAS F. REILLY

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
AND SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

Joint Hearing on June 23, 2004

Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market

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Chairman Ney, Chairman Bachus, Ranking Member Sanders, Ranking Member Waters, and Members of the Subcommittees:

Introduction and Background:

I appreciate the opportunity to present the views of Massachusetts Attorney General Tom Reilly's Office concerning the subprime mortgage market. As you gather information about how state laws and law enforcement actions may affect the subprime mortgage market, I can offer the perspective of a law enforcement office with a long history of bringing cases against mortgage lenders that have engaged in unlawful practices, including cases against subprime mortgage lenders. I will highlight a recent case we brought against First Alliance Mortgage Company.

The experiences of the Massachusetts Attorney General's Office will lend some perspective to the questions you pose concerning whether state law enforcement actions affect the flow of liquidity in the subprime mortgage and lending markets. Our state laws and law enforcement efforts have not resulted in any reluctance on the part of mortgage lenders to do business within the Commonwealth. In fact, according to our Division of Banks, the mortgage lending business has grown in Massachusetts.[1]

Enforcement Action by the Massachusetts Attorney General Against First Alliance Mortgage Company:

First Alliance Mortgage Company, an Irvine, California based mortgage lender, obtained a license to make mortgage loans in Massachusetts from the Massachusetts Division of Banks in

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[1] For instance, according to the Massachusetts Division of Banks, there were 297 licensed mortgage lenders in the Commonwealth for the year 1999, compared with 417 for the year 2004. The Division licenses both mortgage lenders and mortgage brokers, and reports that there has been a steady increase in the numbers of licensed mortgage lenders and brokers since 1999, the last year for which total numbers are readily available. In 1999, there was a combined total of licensed mortgage brokers and lenders of 627, in 2000 there were 698, in 2001 there were 754, in 2002 there were 837, in 2003 there were 953, and in 2004 there were 1,082.

March of 1997. The Division of Banks conducted a routine inspection of FAMCO's books and records approximately one year later, and during this examination found that FAMCO was regularly charging Massachusetts borrowers more than twenty points for their mortgage loans. Concerned with these extremely high points charges, the Division of Banks issued an examination report to FAMCO on May 7, 1998 which took note of the points problem, and referred the matter to the Massachusetts Attorney General's Office for enforcement.

The Massachusetts Attorney General's Office brought suit against FAMCO on October 30, 1998 in Suffolk County (Boston) Superior Court. The main allegation in the Commonwealth's complaint was that FAMCO had violated a regulation of the Massachusetts Consumer Protection Act by providing a mortgage loan with "terms which significantly deviate from industry-wide standards or which are otherwise unconscionable."[2] The complaint alleged other general violations of the Massachusetts Consumer Protection Act, but the lawsuit was intended to focus cleanly and swiftly on the points charges, which were clearly unconscionable by Massachusetts standards.[3]

The FAMCO case proceeded along a normal litigation path after we filed the civil complaint: we sought and obtained a preliminary injunction in the case in November of 1998 which limited FAMCO to charging no more than five (5) points on new loans made (and which resulted in FAMCO ceasing to do business in Massachusetts[4]), we sought and obtained discovery including

[2] 940 Code of Massachusetts Regulations, Section 8.06(6).

[3] The industry-wide standard for points charges in the Commonwealth among non-bank mortgage lenders providing loans to consumers whose credit ranged from A to C, during the period that FAMCO made mortgage loans here (between March 1997 and November 1998), was a range of from zero to four.

[4] During the hearing on the Commonwealth's application for a preliminary injunction, FAMCO informed the state court that it would not be able to afford to continue to do business in Massachusetts if it were to be limited to charging consumers only five points. After the court issued its order, FAMCO closed its Massachusetts branch office, and ceased making loans in Massachusetts.

all of the loan files of the Massachusetts borrowers, and we served a motion for summary judgment on February 15, 2000.

FAMCO only did business for about one year in the Commonwealth -- and made only 299 mortgage loans to Massachusetts residents. But the damage done to our consumers was significant: we calculated that from the 299 loans made, Massachusetts consumers paid FAMCO more than three million dollars in points charges alone.

On March 23, 2000, a year and a half after the Commonwealth instituted its action against FAMCO and before our civil suit was resolved, FAMCO filed for bankruptcy protection in the Central District of California.

That bankruptcy action was not resolved until March 21, 2002, and at the end of the day, Massachusetts consumers saw only cents on the dollar in terms of their actual recovery.

During the course of the litigation, here is what we learned about FAMCO's practices in Massachusetts:

> a) Of the 299 loans that FAMCO made to Massachusetts borrowers, 35.57% contained points charges in excess of 20 (in two cases, borrowers paid <u>more than 30 points</u>); 73.15% contained points charges in excess of 10; 96.64% contained points charges in excess of five; and only 3.36% contained points charges that were less than five.
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> b) Although FAMCO characterized itself as a “subprime lender,” of the 299 loans made in Massachusetts, 20% were made to borrowers who were rated A or A-, according to FAMCO’s standards. There appeared to be no correlation between the points charged and credit scores.[5] The Massachusetts FAMCO borrowers were middle-class and did not necessarily meet the traditional definition of “unsophisticated” consumer. Most were long-standing homeowners in their communities, whose equity in their homes represented their largest asset.[6]

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[5] According to the loan files, FAMCO made mortgage loans to the following numbers of consumers in the following credit-rating categories: A or A-: 59; B or B-: 115; C or C-: 115; and D: 8.

[6] One FAMCO borrower, for example, was a single woman, aged 61. She borrowed the total sum of $47,257, to be paid back in 30 years. She had an adjustable rate note that had an initial interest of 9.49%. The consumer paid more than 25 points, or $<u>11,098.77</u>, in points. FAMCO had designated this woman an "A" rated borrower -- that is, a consumer whose credit history and debt-to-income ratio would have qualified her for a conventional, conforming mortgage loan with competitive rates and costs. She was a middle-class borrower from a good neighborhood near Boston.

c) 187 of the 300 FAMCO loans (that is, more than half of the loans) had adjustable rates of interest (as opposed to fixed rates). Regardless of market conditions, these interest rates were set up so that they would never decrease. Instead, the interest rates, and the consumers' monthly mortgage payments, increased every six months. To calculate the increases, FAMCO used a LIBOR index plus a large margin. (The margin most often used was 7.99.) This presented significant confusion for many borrowers who did not understand that the initial rate of interest was a teaser rate. Many consumers believed that when prime rates decreased, their interest rates (and monthly mortgage payments) would correspondingly decrease, and were surprised to learn that this was not the case.

d) Twenty-eight Massachusetts borrowers had their loans "flipped." That is, FAMCO refinanced its own mortgage loans shortly after the original loans were consummated. Most of these borrowers paid the same level of points again, and again these points were financed. For example, one couple in their 60s paid $15,757 in points the first time (or 20.96 points), and when they refinanced with FAMCO just 14 months later, paid $15,778.61 (or 15.32 points) the second time. 23 of the 28 loans were flipped within one year of the first loan.

e) FAMCO telemarketers were taught to urge consumers to get new FAMCO loans at every opportunity. If consumers called for a loan payoff figure, telemarketers were instructed to sell a new loan. If consumers were late making one payment, FAMCO telemarketers were instructed to call consumers to urge them to refinance.

f) The Massachusetts consumers did not seek out FAMCO. They were solicited. The solicitations were misleading, and included, for example, the suggestion that the loans contained no closing costs, even though most consumers paid enormous points charges.

g) FAMCO trained its loan originators to memorize and follow a deceptive sales pitch called the "Loan Officer Track."[7] The "Track" instructed loan officers to confuse and lie to consumers. For instance, loan officers were trained to tell consumers that if consumers made monthly mortgage payments that were larger than those they were required to make, consumers would pay off their loans early and at a significant savings. The loan officers were directed to refer to this section of the "Track" in response to possible questions about the substantial points charges, and to suggest that the points charges, which were set forth on written disclosure statements as required by law, merely represented a worst case scenario. But this representation was false: every FAMCO consumer paid the points in full on the day the loan closed.[8] Further, when consumers

[7] The loan originators FAMCO sought to hire were not employees who had demonstrated experience in the mortgage lending business but instead were car salespeople with an established record in car sales. It was not insignificant that their training consisted solely in getting them to memorize the "Track" rather than in instructing them on mortgage lending laws.

[8] The FAMCO consumers financed their points payments; the points charges were added

> make larger monthly payments than those required by their mortgages and notes, they will save money over the life of the loan on *interest* payments, but this strategy will not affect *points* charges, which are static and are paid at the inception of the loan.

FAMCO's lending practices became well known. Before the bankruptcy action was completed, FAMCO was sued, in addition to the first suit filed by the Massachusetts Attorney General, by the Attorneys General of Minnesota, Illinois, Florida, California, and Arizona, the New York State Banking Department, the Federal Trade Commission, AARP, and private counsel in individual and class actions. Within the bankruptcy case, all of the plaintiffs worked cooperatively, focused on the common aspects of the laws in our states and in the FTC Act, and coordinated our efforts. Ultimately, FAMCO, Brian Chisick, the person primarily responsible for the business, and Sarah Chisick, his wife, were together ordered to provide restitution to approximately 18,000 borrowers nationally. The Chisicks were ordered to contribute the sum of $20 million towards consumer redress, and FAMCO was ordered to liquidate its business.

To date, the redress fund has collected approximately $85 million, including tens of millions of dollars from FAMCO's liquidated assets and the $20 million from the Chisicks, and approximately $63 million of that fund have been distributed to consumers. Although this was an extremely significant dollar settlement against a predatory lender, especially the contributions the Chisicks made to the settlement, it still was not enough to make consumers whole. Ultimately, Massachusetts consumers received only cents on the dollar, as was the case for consumers nationally.

The coordinated plaintiffs made a very important decision to bring an action against Lehman Brothers, the investment firm that had securitized FAMCO's loans. Because Lehman Brothers' involvement came after FAMCO ceased doing business in Massachusetts, our office was not actively involved in the litigation against Lehman Brothers, but the suit resulted in a tremendous victory: the jury found that FAMCO systematically defrauded borrowers, and that Lehman Brothers aided and abetted in the fraudulent scheme by continuing to securitize loans even after it became plain that FAMCO was engaging in unscrupulous practices. The jury found that the total damages to consumers nationally was about $51 million. The jury was asked to determine the extent of Lehman Brothers' responsibility, and concluded that Lehman Brothers was liable for 10% of the consumers' harm (while finding that FAMCO was 90% liable). Thus, Lehman Brothers was ordered to pay the sum of approximately $5.1 million. Because this decision is

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onto the principal amount of the loan. This meant that consumers paid interest on the points charges, and it also meant that consumers were more easily duped – consumers were simply not alerted to the large points payments they were making since FAMCO lied about the charges, and since they were not asked to write a check to cover the points costs.

currently on appeal, Lehman Brothers has not yet paid on this judgment. If the jury's verdict is upheld, consumers may see another distribution.

Lessons Learned from the FAMCO Case:

The most difficult aspect of the FAMCO case was that even after learning all we did about this lender's bad practices, we were unable to make consumers whole. The bankruptcy case was completed, the redress funds were delivered, but our consumers did not receive full restitution. Ultimately, the losses to each Massachusetts consumer were substantial.

At the time when we began our suit against FAMCO, Massachusetts did not have a law making the assignees of the FAMCO loans specifically liable for FAMCO's conduct, and we did not sue any party other than FAMCO in our state litigation. The FAMCO case made painfully clear to us the extent to which consumers can be harmed by an unscrupulous lender, even when there are reasonably good consumer protection laws on the books. We realized that FAMCO was able to accomplish a fair amount of harm in Massachusetts, and a large amount of harm nationally, because of its access to the secondary market, and in part for this reason we would look closely at the possibility of naming secondary market defendants in the future.

Were we to file a case in Massachusetts state court today against a predatory lender such as FAMCO, we would likely sue assignees in order to ensure that any money judgment obtained would be satisfied. We would be able to do so because the Massachusetts Commissioner of Banks adopted "high cost" loan regulations, which became effective on March 22, 2001, and which contain assignee liability provisions.[9] In addition, there is a bill currently pending in the Massachusetts legislature to enact a law to make assignees liable for the acts of their assignor mortgage lenders, again in the context of "high cost" loans. These regulations (and prosepective law) give us important tools to get full relief for our consumers.

We also note the important function that assignee liability may play within the mortgage lending system. Secondary market entities such as Lehman Brothers have strong and ready tools available to perform due diligence of a lender such as FAMCO. It is likely that, had Lehman Brothers exercised even minimal due diligence in reviewing FAMCO's lending practices, and had it known it would be held liable for serious deficiencies, it would not have provided a lifeline to FAMCO by way of securitizing its loans. Had the sources of funding from the secondary market not been available to FAMCO, it would presumably have ceased operating, and victimizing consumers, much earlier.

Given FAMCO's plainly egregious conduct, it was important for the multiple plaintiffs in the FAMCO case to bring suit against Lehman Brothers, and to establish that a company such as Lehman Brothers which had knowledge (and which could fairly easily have learned yet more) about FAMCO's tactics cannot escape liability. This is important from a law enforcement

[9] 209 CMR 32.32.

perspective: all of the participants in the making of consumer mortgage loans should be held accountable for the making of unlawful mortgage loans. If they are not, then what we will see at the end of the day is that families – the least sophisticated among all of the players – will be left holding the bag, and the bag will be empty.

Other Law Enforcement Actions By the Massachusetts Attorney General Against Subprime Mortgage Lenders:

In addition to the case against FAMCO, the Massachusetts Attorney General brought an action in 1996 against United Companies Lending Corporation ("UCLC"), a Louisiana based mortgage lender that charged consumers 10 points, plus sizeable mortgage broker fees which were not disclosed as required by Massachusetts law, among other unlawful practices. UCLC also filed for bankruptcy protection, but the Commonwealth obtained a final judgment, including restitution payments to consumers in the approximate total sum of $860,000, just before the bankruptcy action was filed.

In 2002, our Office and 18 other state Attorneys General and financial regulators settled claims against Household Finance and its Beneficial Finance unit, a settlement every state in the country eventually joined. We alleged that Household had engaged in a number of shady mortgage lending practices, including luring consumers by way of deceptive "live checks," flipping loans, and engaging in bait and switch tactics that left consumers with two loans at closing rather than one, and aggregate loan amounts at more than 100% of the value of the home. Our settlement contained injunctive relief which changed the way the company does business, and consumers across the country shared in a $484 million redress fund.

Conclusion:

The Commonwealth of Massachusetts has strong and reasonable consumer protection laws on the books, and the Massachusetts Attorney General has used these laws to bring cases against subprime lenders that have engaged in unlawful practices. These laws and our enforcement efforts have not stopped mortgage lenders from doing business in the Commonwealth.

The Commonwealth needs to be in a position to adjust and strengthen its consumer protection lending laws to the unscrupulous practices which develop here. As a state law enforcement office, we want to be in the position of being able to file the strongest possible lawsuits to protect our residents when unscrupulous lenders attempt to steal our residents' hard-earned home equity.