

Testimony of
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Testimony before the
House Committee on Financial Services

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Hearing on
“Federal and State Enforcement of Financial Consumer and
Investor Protection Laws”

Mortgage Fraud Enforcement Actions by State Attorneys General

I. Introduction and Background

Congressman Frank and members of the Committee, thank you for inviting me to testify at today's hearing regarding mortgage fraud enforcement actions brought by state and federal agencies. As the chief consumer advocate for the state of Illinois, I am pleased to share information about my efforts – and the efforts of my fellow attorneys general around the country – to prosecute the various forms of mortgage fraud that contributed to the home foreclosure crisis and the resulting economic recession.

Protecting Illinois homeowners from predatory mortgage lending has been a priority of mine since I took office as Illinois Attorney General six years ago. Like many state attorneys general, I recognized long ago the signs of a crisis in the making. I remember meeting with my consumer fraud lawyers and being told that this terrible wave of foreclosures was coming – years before it made the headlines. I also recall attending a meeting with federal regulators two years ago at which I voiced my concerns about the oncoming crisis. At that time, however, Wall Street was still making money on mortgage-backed securities. The federal regulators did not share my concerns.

In my role as Illinois' chief enforcer of consumer protection laws, I have brought enforcement actions against some of the largest mortgage lenders in the nation for engaging in the unfair, deceptive, and fraudulent lending practices, the same unlawful practices at the center of the housing crisis. Additionally, because I believe that homeowners are best protected by strong regulation and oversight of mortgage lending *at the point when loans are originated*, I have drafted and lobbied successfully for the passage of state legislation that provides significant protections at this stage, including requiring ability-to-pay underwriting standards for all mortgage loans, severely restricting the use of stated income or so-called "liar" loans, and creating a fiduciary duty between mortgage brokers and *borrowers*. But ultimately, my efforts and those of other state attorneys general were unable to fill the void created by what I view as an abdication of meaningful oversight at the federal level, and now we are all in the challenging position of pursuing the wrongdoers after the damage is done.

As a prefatory matter, I wish to point out that it is impossible to neatly unwind a single mortgage transaction, let alone millions of them. In an era when home loans are structured as complex financial instruments, residential mortgage loan transactions involve a bewildering array of different corporate entities and individuals. These participants range from appraisers, mortgage brokers, and title companies to loan funders, securitizers, and ratings agencies. Every step in a mortgage transaction is fraught with the possibility of fraud and wrongdoing. When things go wrong on a massive scale, as they have now, it is no simple matter to make every harmed homeowner whole again, or to hold every culpable party legally accountable for the damage they've done. A state attorney general – or any regulatory agency – has a myriad of potential wrongdoers to investigate and potentially prosecute, and thus it is critical that all of the agencies

testifying today develop an understanding of how we can better work together to address this crisis in a way that maximizes our respective regulatory and prosecutorial authority.

As we know, the home foreclosure crisis has profoundly affected not only homeowners but also taxpayers, cities, states, and the nation as whole. I have heard from citizens in my own state who can hardly believe the enormous sums of taxpayer dollars flowing into financial institutions to keep them afloat. In return for their trillion-dollar investment, these same citizens demand accountability, and, just as important, they demand that something be done to stem the swelling tide of home foreclosures in their communities.

As Attorney General, I believe that it is my obligation to pursue, within the boundaries of my authority, those who engaged in predatory practices that have adversely affected us all, and I can assure you that my fellow attorneys general are united in this belief. In the words of the Congressional Oversight Panel, “State regulators have a long history as the first-line of protection for consumers. . . . [S]tates first sounded the alarm against predatory lending and brought landmark enforcements against some of the biggest subprime lenders...” (*Special Report on Regulatory Reform*, January 2009, p. 32).

Indeed, state attorneys general have aggressively pursued enforcement actions against predatory lending practices since the 1990s, on both the civil and criminal levels. What has changed as a result of the current crisis are the remedies we seek. These days, not only do we seek monetary relief for consumers who have lost their homes as a result of these illegal practices, but – just as critically – we are crafting remedies that permit thousands of struggling homeowners to modify their mortgages so that they have a fighting chance of saving their home. As we discuss today the best ways to hold mortgage lenders accountable for placing millions of homeowners into loans they could not afford to repay, it is my hope that we do not forget the paramount importance of saving homes and stabilizing communities.

My testimony is divided into two parts. First, I will summarize the enforcement actions brought by my office and the other state attorneys general against participants in the mortgage lending market who have engaged in mortgage fraud and other violations of consumer protection laws and regulations. This part will include a summary of my office’s investigation of and lawsuit against Countrywide Home Loans, and my eventual settlement with Countrywide’s new owner, Bank of America. In the second part of my testimony, I will identify some of the key impediments to effective enforcement of fraud and other consumer protection laws and regulations by state attorneys general.

II. Attorneys General Prosecution of Predatory Mortgage Lending Practices

Civil Actions

The attorneys general are not newcomers to the arena of predatory lending. We have been pursuing these practices since as early as 1998, when the states of Illinois, Massachusetts and Minnesota initiated civil suits against First Alliance Mortgage Company (“FAMCO”), a non-depository state chartered mortgage lender based in California.

FAMCO was selling high cost loans to prime and subprime borrowers, and then bundling and selling those loans to the Wall Street firm Lehman Brothers. FAMCO's mortgage loans largely consisted of refinances into exotic 2/28 ARM products. As a result of the litigation – which was subsequently joined by other states and the FTC – FAMCO was forced out of business and into bankruptcy. Pursuant to a settlement agreement in 2002, the government entities recovered well in excess of \$50 million in restitution for consumers' losses. Since those losses were sustained at the beginning of the housing bubble, when borrowers were still building equity in their homes, they were for the most part internalized by the borrowers themselves, in the form of higher monthly payments and lost equity. A homeowner placed in an abusive FAMCO loan could eventually refinance out of it. The losses had not yet spilled over significantly into the external marketplace.

While the FAMCO cases were still being settled, the attorneys general launched an investigation into the mortgage practices of the state chartered subprime mortgage lender Household Financial. That investigation targeted many of the practices that bring us to this room today: Household engaged in a wide scale pattern and practice of misrepresenting loan terms, selling loans with prepayment penalties and balloon payments without consumers' knowledge, packing credit insurance products into consumers' loans, refusing to give consumers loan payoff information, and writing loans that Household knew consumers could not afford. The multistate investigation of Household culminated in 2002 with a \$484 million dollar restitution settlement and injunctive relief remedying the company's various fraudulent, deceptive and unfair lending practices.

Even while the attorneys general were finalizing the settlement with Household, it became clear to us that there were problems with the largest subprime lender in the country at the time, the California-based lender Ameriquest. Ameriquest also received its funding line from Wall Street firms. These same firms bought and securitized the subprime loans Ameriquest sold. For those of us on the state level, the Ameriquest investigation marks the moment when we began to see the underwriting practices of mortgage lenders erode at a disturbingly accelerated pace. In 2002, Ameriquest was originating loans with an average loan-to-value ratio of 74 percent. Two years later, the ratio had risen to 81 percent. Ameriquest had also ramped up its originations of stated-income loans, that is, loans that permit the borrower merely to state his or her income without further review. By 2003, Ameriquest was originating almost 30 percent of its loans – which were all subprime – as stated-income or limited-documentation loans.

Our multistate investigation of the nation's largest subprime mortgage lender revealed that Ameriquest engaged in the kinds of fraudulent practices that other predatory lenders subsequently emulated on a wide scale. These practices included: inflating home appraisals; increasing, at closing, the interest rates on borrowers' loans or switching their loans from fixed to adjustable interest rates; and promising borrowers that they could refinance their costly loans into loans with better terms in just a few months or a year, when these borrowers did not have any equity left to absorb another refinance. Ameriquest also locked borrowers into costly loans by including three-year prepayment

penalties on loans with a two-year introductory rate that reset to a higher rate at the end of two years. These penalties were added because Wall Street investors preferred and paid more for loans with prepayment penalties.

As a result of the multistate investigation, 49 states and the District of Columbia entered into a \$325 million settlement agreement with Ameriquest in 2006. Just as important as monetary relief, the settlement contained extensive injunctive provisions that went to the heart of the industry's predatory lending practices. These provisions included: early disclosure of essential terms of the loan in an easily understood and concise manner, and the additional requirement that, if the terms changed, they would be re-disclosed prior to closing; scripts to be used during the sale of the loan setting out what borrowers would be told about the essential terms of their loan; provisions ensuring that Ameriquest would deal at arms-length with appraisers; restrictions on placing prepayment penalties on hybrid ARMs, so that borrowers would not be trapped in loans when their interest rates reset upward; restrictions on serially refinancing borrowers; and requiring Ameriquest to use a pricing system that would provide the same rate, including the same number of discount points, to similarly situated borrowers.

The intent of the Ameriquest settlement was to create a lender code of conduct that would stem the tide of abuses in the subprime mortgage market. However, shortly after the settlement was finalized, the subprime mortgage market began to contract. Ameriquest went under, and the lender code of conduct was never fully implemented. Despite its ultimate failure, Ameriquest's climb to the top of the market had paralleled an explosive growth in subprime lending that irrevocably changed the economic landscape. Due to the serial refinancing of their mortgages, many borrowers no longer had significant amounts of equity in their homes as of 2006. The days when borrowers could internalize the enormous costs of predatory mortgage lending were over, and equity-poor homeowners began defaulting in ever-increasing numbers.

By the fall of 2007, with the subprime mortgage market starting to crumble, my Office knew that Countrywide Home Loans merited a closer look. At the time, Countrywide was a state-licensed lender whose parent corporation also had a federal thrift subsidiary. Countrywide was also the largest prime and subprime mortgage lender in the nation. In September 2007, my office, in conjunction with the California Attorney General's Office, sent subpoenas to Countrywide pursuant to our authority under our states' consumer protection laws. What we found as a result of those subpoenas and interviews with former employees and mortgage brokers was that Countrywide, in relentless pursuit of greater market share over the last several years, had engaged in a wide range of deceptive practices. These practices included the inappropriate loosening of underwriting standards, particularly through the use of stated income loans to qualify borrowers for loans that they could not actually afford. We also found that Countrywide had engaged in a pattern and practice of qualifying borrowers at "teaser" interest rates, as opposed to the fully indexed and fully amortizing interest rate, setting borrowers up for an unaffordable payment shock. Countrywide also deceptively sold complex loan products with very risky features to borrowers who did not understand and could not afford them. The complexity of these products reached its peak in Countrywide's popular pay option ARM

prime product, which contained a negatively amortizing feature, providing a structure to put the borrower upside down on a loan by paying less than the interest owed on the loan. Additionally, we found that Countrywide structured unfair loan products with risky features, oftentimes combining several layers of risky features into one extremely risky loan – for example, a stated-income 2/28 hybrid ARM with a loan-to-value ratio of over 95 percent, for which the borrower was qualified only at the initial teaser rate.

Furthermore, our investigation revealed that Countrywide’s explosive growth was paralleled by the demand from the secondary market for loans with nontraditional risky features. Through the securitization process, Countrywide extracted hefty over-head charges, then shifted the risk of the failure of these non-traditional loans to investors. Moreover, securitization allowed Countrywide to tap those investors for much needed capital to fuel its origination process and reach its goal of capturing more and more market share. To facilitate the increase in loan origination volume, Countrywide relaxed its underwriting standards and sold unaffordable and unnecessarily more expensive mortgage loans to millions of American homeowners.

On October 6, 2008, Illinois and several other states announced a settlement with Countrywide that established a mandatory loan modification program. To date, almost half of the states have signed on to this agreement. The settlement covers approximately 400,000 borrowers nationwide and, by our estimate, will provide 8.7 billion dollars in loan modifications to borrowers. Countrywide will also pay approximately 150 million dollars into a foreclosure relief fund for payments to distressed homeowners or for programs to help distressed homeowners.

Unlike previous settlements with subprime lenders, the Countrywide settlement did not contain mandatory injunctive provisions governing the company’s future lending practices. There is a simple but disturbing reason for this: During our investigation, Countrywide transferred its mortgage origination business from its state-licensed subsidiary to its federally chartered thrift subsidiary.

The enforcement actions I have summarized are by no means fully representative of the extensive efforts undertaken by state attorneys general to combat predatory mortgage lending in the run-up to the foreclosure crisis and in its wake. As a measure of the vast scope of state-level enforcement actions against predatory mortgage lenders in recent years, I offer the following, non-exhaustive list:

In October of 2007, the Massachusetts Attorney General Martha Coakley filed a civil fraud suit against the large California based subprime lender Fremont General for predatory lending practices. In that case, a Massachusetts court granted General Coakley’s request for injunction that prohibited Fremont from initiating or advancing foreclosures on loans that are “presumptively unfair.” The Attorney General was then given the opportunity to review the loans and object to any future advancement of the foreclosures.

In June, 2008, General Coakley sued another large subprime lender, Option One Mortgage Company, and its parent H&R Block, for selling risky subprime products that were unaffordable and destined to fail.

In early 2007, the Ohio Attorney General filed a civil suit against the large California subprime lender New Century as it filed for bankruptcy. The Attorney General obtained a temporary restraining order prohibiting New Century from initiating any new loans or pursuing any foreclosure actions in Ohio. The injunction acted as a moratorium on New Century foreclosures in Ohio, thus giving the Attorney General's Office an opportunity to review the loans for evidence of predatory practices.

In December of 2007, the New York Attorney General filed a civil suit against the nation's largest mortgage and property services company, eAppraisalIT, for inflating the value of home appraisals. According to Attorney General Cuomo, the scheme was a response to pressure from Washington Mutual. The inflated appraisals would allow Washington Mutual to write more loans for more money than the collateral would justify.

In a continuation of its investigation of appraisal fraud, the New York Attorney General announced in early 2008 that the nation's two largest purchasers of home loans, Fannie Mae and Freddie Mac, had entered into cooperation agreements requiring them to only buy loans from banks that meet new standards designed to ensure independent and reliable appraisals. The agreements created a new organization to implement and monitor the new appraisal standards called the "New Home Valuation Protection Code."

In addition, numerous attorneys general have brought civil lawsuits against brokers, title companies and appraisers including the attorneys general of New York, Ohio, Iowa, Colorado, and Massachusetts. My Office has prosecuted a number of these individuals and companies in the past few years.

Criminal Actions

The attorneys general across the country have also begun pursuing mortgage fraud criminally. Targets have included dozens of mortgage brokers, loan processors, and bank officers. Additionally, in the first week of March there were guilty pleas in Minnesota, Delaware, North Carolina and Connecticut and sentences in Florida and Vermont for suits brought by the attorneys general in those states. Several states – including Texas, Colorado, Massachusetts, California, Washington, New Jersey, Ohio, Florida, and my own state – have brought criminal actions against various state participants in the mortgage arena, including attorneys, brokers, title companies and appraisers.

My Office and a number of other states participate in Mortgage Fraud Task Forces. These task forces are usually made up of federal, state, and local prosecutors who join forces to target the most egregious mortgage frauds. These task forces can be used to coordinate investigations and prosecutions of mortgage fraud and to promote inter-agency information-sharing.

III. Impediments to State Attorneys General Pursuing More Mortgage Fraud Enforcement Actions

State enforcement actions have been hamstrung by the dual forces of preemption of state authority and lack of federal oversight. The authority of state attorneys general to enforce consumer protection laws of general applicability was challenged at precisely the time it was most needed – when the amount of subprime lending exploded and riskier and riskier mortgage products came into the marketplace. For example, the Office of the Comptroller of Currency has taken the position over the past several years that it has authority to prevent state attorneys general from enforcing state fair lending and consumer protection laws against federal banks and bank subsidiaries. This position effectively created a void that was previously covered by state consumer protection and civil rights laws.

At the same time that preemption of state consumer protection powers gained ground, federal agencies failed to fill the gap in regulation with uniform market-wide standards that ensured lenders did not engage in fraudulent, deceptive or unfair lending practices. Our federalist system of government is premised on the notion that federal and state regulation can co-exist and are in fact complementary. Moreover, even if sufficient federal regulations had been promulgated, they are only effective to the extent that the administration in power is interested in enforcing them. Recognizing the important role of the state attorneys general will restore an effective check on banking and financial institutions.

The void created by preemption in the face of a failure of federal oversight added a number of impediments for state attorneys general in pursuing enforcement actions against predatory lenders. While it is too late to remove some of these impediments, there are some obstacles that can be eliminated to restore to state attorneys general the ability to successfully prosecute predatory lending in the future.

Preemption: Attorneys general have to make a difficult decision when we come upon lending abuses by federally chartered lenders; we have to weigh whether to expend our limited resources fighting the preemption battle or move on to pursuing the many other lenders engaging in the same practices. Many of the lenders who engaged in fraudulent, deceptive and unfair practices are no longer in business, and we are hamstrung in our efforts to pursue the remaining lenders, because most of them are now sheltering under the protections of federal charters. Such charters should not entitle lenders to a blanket exception from state prosecution for violating generally applicable state and federal consumer protection laws.

Failure to Include Consumer Protection in Federal Underwriting Standards: In the run up to the crisis, many federally chartered lenders were engaging in the same predatory lending practices as state-licensed entities, particularly through their subsidiaries. Federal regulators, however, in contrast to state attorneys general, did little to curb the abuses of those within their control. With the proliferation of increasingly sophisticated and complex loan products in the marketplace, the federal regulators should have taken steps

to ensure that lender underwriting standards protected consumers. Such standards should have included a requirement that lenders evaluate a consumers' ability to repay their mortgage loan. But instead of exercising their authority to protect consumers, federal regulators focused almost entirely on lender safety and soundness concerns. This focus was further narrowed by the federal regulators' limited metrics for assessing safety and soundness, which centered only on the viability of lending institutions. In essence, the federal government was sending the message to financial institutions that their profitability was the paramount concern.

In the absence of common sense underwriting standards on the federal level, states found it extremely difficult to enact underwriting standards and other lending reforms for state-licensed entities. As a result, states had to rely on state consumer protection laws to regulate lending abuses. This proved equally difficult. It was no easy matter to prove that questionable products and practices were illegal when there were no written federal rules or regulations specifically prohibiting them. Even as the first tremors were felt in the mortgage market, the perceived legality of the products and practices that fomented the oncoming crisis was reinforced by the federal regulators' failure to advance or support the states' arguments that certain products and practices were unfair and deceptive. When, with the issuance of Guidance, federal regulators finally weighed in on the appropriateness of these products and practices, it was too little, too late.

States continue to face enforcement issues caused by weak federal regulation. For instance, in 2007, Illinois passed legislation designed to protect consumers from the use – and abuse – of stated income documentation and to ensure that consumers were not placed in unaffordable mortgages. The stated income limitations in the Illinois statute apply to all loan products. By contrast, the Federal Reserve Board's recently announced limitations on stated income loans apply only to a certain category of loans. This is but one example of the many gaps between state and federal standards of protection. When these gaps occur, it is almost always the states that accord the greater level of protection. As a result, state-regulated entities are prohibited from engaging in certain practices that federally-regulated lenders can still do. This causes problems for the state attorneys general. Even with the housing market in ruins, mortgage brokers and others involved in the worst of the lending abuses are fighting to roll back consumer protections passed by state legislatures, and in service of this campaign, they invoke the “level playing field” argument. The attorneys general hear from state lenders and brokers that they simply want to offer the same products and use the same method of underwriting as do the federally chartered institutions. As one example, mortgage brokers in Illinois are currently arguing that the no documentation underwriting standards for the FHA streamline refinance product obviate any need to determine whether borrowers can in fact afford the new loan. Recent reports of rising default rates for FHA loans – including the FHA streamline refinance product – suggest that what is needed is not looser underwriting standards in Illinois, but stronger underwriting standards at HUD.

Resources: Investigation of the very large lenders requires an enormous investment of resources for the states. During the Countrywide investigation, for example, my lawyers

reviewed tens of thousands of documents and conducted numerous interviews of consumers and brokers. We also hired experts to assist us in this complex analysis.

While significant resources are required to prove lender liability, even more resources are required to prosecute individuals. To recover money from CEOs and executives of lenders who engaged in fraud, state attorneys general have to meet the high burden of proving individual liability for corporate activities. Despite these impediments, some states, including Illinois, have named Countrywide's former-CEO Angelo Mozilo in connection with their Countrywide lawsuits. These cases are still pending.

It is important to note that very large lenders are not the only targets of state attorney general enforcement actions. For the last few years, we have been investigating and prosecuting the many state-licensed participants in the market meltdown, especially mortgage brokers. These cases are so numerous that we could spend all of our time and resources pursuing them. State attorneys general simply do not have the resources to investigate every bad actor in the lending arena. Strong federal oversight of lender underwriting practices will go a long way toward decreasing the amount of abuse at the broker level.

TILA Disclosure Defense Used as a Shield: The lenders used TILA disclosures as a shield for extremely complicated mortgage products that very few consumers could understand. Pay Option ARMs that negatively amortize depending on the payment the consumer chooses is a good example. These products simply were not appropriate for the average homeowner and the TILA disclosures did not help the consumer to understand the product. Lenders point to compliance with TILA disclosures to immunize them from any claims that they violated state consumer protection laws.

Risk Shifting: The risk shifting caused by the largely unregulated securitization of mortgage loans causes two additional problems for state attorneys general. First, the risk shifting multiplies the number of potential targets that states may have to investigate. Second, the unchecked risk shifting incentivized imprudent underwriting at every level of the loan transaction and removed potential liability for that poor underwriting. If the incentives to engage in imprudent underwriting are not removed, then state attorneys general will fight a losing battle to regulate an ever-growing number of targets.

IV. Conclusion

To sum up, some state attorneys general have been predicting the current lending crisis for years, but few listened. Banks, lenders and mortgage brokers lobbied aggressively to prevent any regulation at either the state or federal level. It really was not until investors started losing money and Wall Street was impacted that it has been possible to get any significant legislative attention paid to these issues. There are lessons to be learned. First, to prevent a crisis of this magnitude from happening again in the future, greater and more rigorous oversight of lenders is needed at the federal level. That oversight must give as much weight to consumer protection as it does to safety and soundness. As we have all seen, these two goals are not mutually exclusive, but rather are inseparably

bound together. Second, the movement to erode state authority to enforce state and federal consumer protection laws must cease. Attempts to exclude state attorneys general from enforcing consumer protection laws have significantly contributed to the distress our residents have endured as a result of these difficult economic times. Finally, given the seemingly infinite number of bad actors responsible for this crisis, all of the agencies here today must maximize our resources by increased cooperation and coordination of enforcement efforts. Thank you for the opportunity to testify before the committee today.