



REPORT TO LAW & LEGISLATION COMMITTEE City of Sacramento

915 I Street, Sacramento, CA 95814-2671

STAFF REPORT
March 4, 2008

Honorable Members of the Law and Legislation Committee

Title: Federal and State Legislation on the Subprime Mortgage Foreclosure Crisis

Location/Council District: Citywide

Recommendation: Staff recommends that Law and Legislation Committee adopt a support position on the following federal and state legislative proposals relating to the subprime mortgage and foreclosure crisis: Foreclosure Prevention Act (S. 2636 - Reid); Homeownership Preservation and Protection Act (S. 2452 - Dodd); Helping Families Save their Homes in Bankruptcy Act (S.2136 - Durbin); Emergency Home Ownership and Mortgage Equity Protection (HR.3609 – Miller); Use of Redevelopment Tax Increment sponsored by California Redevelopment Association (AB 2594 – Mullin and Nunez); Subprime Lending Reform (AB 1830- Lieu); Mortgage Lending (AB 69- Lieu); Mortgage Debt Relief (SB 1055- Machado); Home Financing Programs (SB 1065- Correa); Foreclosure Consultants (AB 180- Bass and Lieu); Assignment of Liability (AB 2359- Jones); Notification for Delinquencies and Fines for Deteriorated Properties (SB926- Perata).

Contact: Cindy Cavanaugh, Assistant Director, 440-1317

Presenters: Lisa Bates, Deputy Executive Director, 440-1316

Department: Sacramento Housing and Redevelopment Agency

Description/Analysis

Issue: Sacramento's economy has been damaged by the fifth highest home foreclosure rate in the nation, caused primarily by lending practices in the subprime mortgage market. Federal and state legislation has been introduced to prohibit or curtail the most reckless subprime lending practices, to prevent further foreclosures through assistance for refinancing or restructuring loans, and to provide funding to local governments to help rehabilitate and sell foreclosed homes to new homebuyers. This report recommends support of the legislation that intends to accomplish these purposes.

Policy Considerations: The proposed action does not change or modify existing housing policy. The 2008 federal and state legislative platforms do not address this policy area.

Environmental Considerations: The proposed recommendation to support pending legislation does not constitute a project under CEQA per Guidelines Section 15378 (b) (4); it does not involve a commitment to any specific project. NEPA does not apply.

Rationale for Recommendation: The authority to reform subprime and predatory lending practices rests with federal and state governments, as does their responsibility to help mitigate the damaging effects on local communities.

Staff recommends support of the following federal legislation, described in Attachment I:

- Foreclosure Prevention Act (S. 2636 - Reid);
- Homeownership Preservation and Protection Act (S. 2452 - Dodd)
- Helping Families Save their Homes in Bankruptcy Act (S.2136 - Durbin)
- Emergency Home Ownership and Mortgage Equity Protection (HR.3609 – Miller)

Staff recommends support of the following state legislation, as described in Attachment I:

- Use of Redevelopment Tax Increment sponsored by California Redevelopment Association (AB 2594 – Mullin and Nunez)
- Subprime Lending Reform (AB 1830- Lieu)
- Mortgage Lending (AB 69- Lieu)
- Mortgage Debt Relief (SB 1055- Machado)
- Home Financing Programs (SB 1065- Correa)
- Foreclosure Consultants (AB 180- Bass and Lieu)
- Assignment of Liability (AB 2359- Jones)
- Notification for Delinquencies and Fines for Deteriorated Properties (SB926- Perata)

Staff also recommends responding to the Federal Reserve's proposed standards for home loan originators, in support of stronger regulation of predatory practices.

Legislative activity around foreclosure is still evolving. Staff will continue to monitor and make recommendations as new proposals are introduced.

Financial Considerations: There are no financial implications related to the recommendations in this report.

Emerging Small Business Development (ESBD): The items discussed in this report have no ESBD impact; therefore ESBD considerations do not apply.

Respectfully Submitted by: 
LA SHELLE DOZIER
Interim Executive Director

Recommendation Approved:

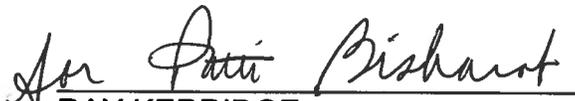

RAY KERRIDGE
City Manager

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SUMMARY OF FEDERAL AND STATE LEGISLATION AND ACTIVITY ON THE SUBPRIME MORTGAGE FORECLOSURE CRISIS

Full text of these bills can be accessed at http://sacramento.granicus.com/ViewPublisher.php?view_id=8 as an attachment to Item 5, Subprime Mortgage Foreclosure Legislation on the agenda for the March 4, 2008 Law and Legislation Committee Meeting. The PDF file contains 12 bills and 131 pages.

Foreclosure Prevention Act (Reid) S. 2636

Introduced 2/13/08, expected to go to floor of Senate after Presidents' Day recess. Trumps S.2455, the "Community Foreclosure Assistance Act of 2007 that provided \$1 billion in Community Development Block Grant (CDBG) funds. There is nothing comparable to S. 2636 in the House of Representatives.

- \$10 billion one-time increase in tax-exempt private activity bond cap to enable local and state housing finance agencies to refinance subprime loans (not previously allowed), provide assistance to first-time homebuyers, and develop multifamily housing. The increase would be allocated among states on the basis of population.

Subprime mortgages are defined as adjustable rate single family loans originated between December 31, 2001 and January 1, 2008 that the bond issuer determines would cause financial hardship if not refinanced. The California Debt Limit Allocation Committee (CDLAC) does not know whether any other restrictions will apply, such as default status of the homeowner.

Impact: if this provision passes, the Sacramento Housing and Redevelopment Agency could apply to CDLAC for authorization to issue tax-exempt mortgage revenue bonds to refinance subprime loans. (We still have the problem of the lender/servicer/investor's willingness to allow a refinance at the home's current value, rather than the loan's outstanding balance.)

- \$4 billion in CDBG funds for purchase, rehabilitation and re-sale of abandoned and foreclosed homes. Funds may be used for loans, grants or other financing mechanisms to nonprofit housing and community development organizations. The U.S. Department of Housing and Urban Development (HUD) will prepare an allocation formula based on state and local foreclosure and default rates and numbers. Homes purchased must be at or below a recent appraisal. Households may be assisted up to 120 percent of area median income.

- \$200 million in foreclosure counseling to Neighborhood Reinvestment Corporation (NRC). Local NRC agencies are NeighborWorks and Sacramento Mutual Housing Association).
- Permission for a bankruptcy judge to restructure loans on the brink of foreclosure for homeowners in a Chapter 13 bankruptcy plan.
- Simplified disclosure on mortgage documents (Truth in Lending Act amendments)

Home Ownership Preservation and Protection Act (Dodd) S. 2452

Introduced December 12, 2007; referred to Senate Banking, Housing and Urban Affairs Committee. 18 co-sponsors, including Senators Boxer and Feinstein

- **Basic consumer protections:** creates a duty for mortgage brokers to consider the best interests of their clients, as is now required of depository lending institutions, and provides for a duty of good faith and fair dealing toward borrowers for all lenders.
- **Steering:** prohibits steering prime borrowers into more expensive subprime loans.
- **Income verifications:** requires lenders to conduct meaningful analysis of borrower's ability to repay the loan (prohibits "no doc" or no stated income loans).
- **Fees:** prohibits prepayment penalties and "yield spread premiums." The latter encourages mortgage brokers to place borrowers into excessively expensive loans by providing a higher fee to the broker.
- **Benefits:** requires that home loans provide a net tangible benefit to the borrower.
- **Enforcement:** allows state attorneys general to enforce the law, and provides that the law does not override state laws.
- **Liability:** unlike current law, allows the borrower to go directly to the current mortgage holder for a cure in the case of a violation, rather than putting the burden on the borrower to find the party responsible.

Helping Families Save Their Homes in Bankruptcy Act (Durbin) S. 2136

Introduced October 3, 2007. Referred to Senate Judiciary Committee. Possibility that it may be folded into Reid's S. 2636 (above). Senator Feinstein is one of 11 co-sponsors.

- Amends federal bankruptcy law to permit homeowners in Chapter 13 proceedings to restructure the mortgage on their primary residence if strict income and expense criteria are met.
- Allows borrowers a 30-year repayment period at a fixed rate of interest.
- Permits bankruptcy judges to waive prepayment penalties and requires notice during the bankruptcy case of any lender fees and charges that may be added to the mortgage debt.
- Exempts up to \$75,000 of the value of a principal residence from being used to pay creditors if the homeowner is 55 or older.

Emergency Home Ownership and Mortgage Equity Protection Act (Miller) HR 3609

Introduced September 20, 2007. Reported out of Judiciary Committee December 12 on vote of 17-15. Current bankruptcy law allows court-supervised loan modifications under a Chapter 13 payment plan for commercial real estate (including yachts), but not for homeowners.

- Amends federal bankruptcy law to allow court-supervised loan modifications for the principal residence of a homeowner under a chapter 13 payment plan. This provision is limited to homeowners with insufficient income to pay their mortgage and who have received notice that foreclosure is imminent.
- Requires that principal balance of loan not be reduced below the value of property, that the term be 30-years, and interest be set at a commercially reasonable market rate.
- Applies only to subprime and non-traditional loans (i.e., interest-only and payment option adjustable rate mortgages)
- Prohibits lender from adding fees or charges while the case is pending unless notice is given to both the debtor and the bankruptcy trustee.
- Eliminates pre-petition bankruptcy counseling if a lender has initiated foreclosure on the homeowner's principal residence.

Purchase of Securitized Loan Pools

Because federal efforts to date have not slowed the rate of foreclosures, Congress is considering legislation that would use federal funds to purchase securitized loan pools at a discount, modify or refinance problem loans within those pools with fixed-rate 30-year mortgages, and do so through private financial institutions.

Loans would be made at current appraised value with soft second government loans making up a portion of the difference between current value and the borrower's ability to pay.

This proposal has not yet been heard in either House or Senate, but is being actively considered as the economic downturn continues.

Federal Reserve Proposed Standards for Home Loan Originators

On December 18, 2007, the Federal Reserve proposed new rules expected to regulate the types of reckless lending practices responsible for the subprime mortgage crisis. Its new standards for home loan originators unfortunately do not, in the opinion of consumer and housing finance organizations, go far enough to prevent predatory lending. The following comments are from an analysis by the Center for Responsible Lending. Comments on the proposed rules are due March 18, 2008. Five major predatory practices are highlighted.

- **Prepayment penalties:** Referred to as "exit taxes" on subprime loans, prepayment penalties trap borrowers in subprime loans. The proposed rule only slightly limits prepayment penalties on adjustable rate mortgages and otherwise allows them to remain effective for five years, with no limit on their size.
- **Yield-spread premiums:** mortgage brokers receive higher fees for originating higher interest subprime loans (when many borrowers, estimated at 20 to 40 percent, would qualify for less expensive financing). These practices remain unregulated in the Federal Reserve's proposals, with the exception of the requirement that yield spread premiums must be disclosed in writing.
- **Ability to repay:** a large part of the subprime mortgage crisis is due to lenders making loans to families without ensuring that they have the ability to repay. The proposed rule applies this ability-to-repay standard to subprime lenders, but makes the rule unenforceable by requiring the borrower to document that the lender was engaged in a "pattern or practice" of such lending. In past Congressional testimony, the Federal Reserve acknowledged that the rule was meaningless. "As a practical matter, because individual consumers cannot easily obtain evidence about

other loan transactions, it would be very difficult for them to prove that a creditor has engaged in a 'pattern or practice' of making loans without regard to homeowners' income and repayment ability."

- Verification of income: the proposed rule would require income documentation for subprime borrowers, but did not require it for "non-traditional loans," those allowing deferred payment of principal or interest (such as payment option adjustable-rate mortgages).
- Escrow of taxes and insurance: many subprime loans were marketed with artificially low monthly payments by excluding taxes and insurance. The Federal Reserve would now require that they be escrowed, but allows a one year opt-out.

STATE LEGISLATION

Use of Redevelopment Tax Increment Funds (AB 2594 - Mullin and Nunez)

- The California Redevelopment Association is proposing changes to redevelopment law to allow the use of both housing setaside and capital ("80 percent") funds to prevent subprime mortgage foreclosures and support low/moderate income homeownership of foreclosed properties.
- Eligible activities include refinancing; the purchase, rehabilitation and resale of foreclosed properties; and credit counseling. The legislation proposes modifications of the term of affordability covenants, certain underwriting standards, and accounting for production.
- The legislation is undergoing revisions and should be introduced shortly.

Proposed legislation

The following bills in the state legislature all deal with regulating the mortgage business to avoid some of the conditions contributing to the subprime lending crisis. There are no funding bills to provide resources to local government.

Subprime Lending Reform Act (AB 1830 - Lieu)

Introduced on January 23, 2008, the bill has been referred to the Assembly Banking and Judiciary Committees. The bill has 36 co-sponsors and appears to be the lead legislation on subprime mortgage reform.

The bill redefines a "covered loan" as a "high cost loan", and establishes "subprime loans" and "nontraditional loans" as subject to regulation. High cost and subprime loans are both defined by differences between their interest rates and the yields on Treasury securities or conventional mortgages. Nontraditional

loans are those that allow borrowers to defer principal and/or interest payments. The summary below pertains to all three loan types, although there are slight differences with high cost loans.

- Requires the lender's reasonable belief that borrower is able to make the required loan payments along with property taxes and insurance. Interest payments must be based on a fully indexed rate. Adds a "rebuttable assumption" that the borrower's total monthly debts should not exceed 45 percent of monthly gross income.
- Requires income verification as well as debt-to-income ratios and residual income information to determine borrower's ability to repay the loan (prohibits "no-doc" loans).
- Does not allow a loan to contain negative amortization (where the payment schedule causes the principal balance to increase).
- Prohibits prepayment fees or penalties.
- Establishes that any refinancing must result in a net tangible benefit to the borrower. The lender also cannot encourage a default on an existing loan in order to refinance it with a subprime or nontraditional loan.
- Prohibits steering – directing a borrower to a more costly loan than they qualify for.
- Prohibits "yield spread premiums" or other incentive compensation that is based on the high subprime interest rate.
- Does not allow an increase in the interest rate as a result of a default; loans also cannot contain a call provision that permits the lender, in its sole discretion, to accelerate the indebtedness except in the case of foreclosure, sale, or fraud.
- Requires the establishment and collection of a monthly escrow for property taxes and hazard insurance; the impound account must remain in existence for five years and until the borrower has sufficient equity to eliminate private mortgage insurance.
- Establishes a Consumer Caution Notice to be disclosed to the borrower and signed prior to loan closing.

Mortgage Lending (AB 69 - Lieu)

Introduced December 4, 2006; passed by Assembly and referred to Senate Banking, Finance, and Insurance Committee.

- The bill requires mortgage lenders to report on their loan loss mitigation efforts for subprime and alternative mortgage products serviced by those entities. The data includes the volume of loans in default and foreclosure and the disposition of loan modifications, including deeds in lieu, short sales, forebearances, refinancings, reduction of interest rates, extension of loan terms, and reduction of principal balances.
- Subprime loans would be reported by loan type: hybrid adjustable rate mortgages (ARMs), fully amortized adjustable and fixed rate loans, loans with interest only features, payment option ARMs, and loans with negative amortization.
- The bill is intended to follow up on the work of the Department of Corporations and its voluntary collection of loss mitigation data with a requirement on mortgage lenders to provide the data on an ongoing basis. Other than gaining transparency in loan loss mitigation, the data should help policy makers determine the obstacles to loan modifications.
- Information would be posted on the web sites of the Department of Corporations and the Department of Financial Institutions.

Mortgage Debt Forgiveness (SB 1055 - Machado)

Introduced January 7, 2008, referred to the Senate Revenue and Taxation Committee.

- Allows borrowers whose lenders agree to forgive some or all of their mortgage debt to exclude that forgiven debt from their income for state tax purposes. (Conforms California tax law to the federal Mortgage Debt Relief Act of 2007)

Home Financing Programs (SB 1065 - Correa)

Introduced February 8, 2008, referred to the Senate Transportation and Housing Committee.

- Authorizes local governments to offer refinancing of home mortgages and reverse home mortgages as part of their home financing programs. Existing law prohibits refinancing unless substantial rehabilitation is undertaken as part of the loan, a condition eliminated in this bill.
- Establishes income limits for participation in local government home financing programs.

Foreclosure Consultants (AB 180 - Bass and Lieu)

Passed by Assembly, sent to Senate Judiciary Committee

- Increases the regulation of foreclosure consultants who offer to rescue borrowers and requires them to register with the Department of Justice. Among other provisions, it would prohibit foreclosure consultants from contracting with an owner to obtain the remaining proceeds from a foreclosure sale of his residence. It permits an owner to cancel a contract up to five days after execution.

Assigning Liability for Wrongful Practices (AB 2359 - Jones)

Assembly member Dave Jones is writing legislation ensuring that lenders and purchasers of mortgage backed securities cannot cut off their liability for failure to comply with their legal obligations in mortgage lending. The proposed bill will also prohibit mandatory arbitration in dispute resolution, a practice found in subprime lending that requires borrowers to waive their rights to defend against foreclosure in a court of law, making it difficult to seek meaningful redress.

Notification of Delinquencies and Fines for Deteriorated Properties (SB 926 - Perata)

Senate Bill 926 (Perata), which was defeated by one vote, will be returning in this legislative session. It provided for enhanced notification of borrowers in default, established tenant protections for defaulted rental property, required documentation of loan modifications, and allowed local governments to fine deteriorated properties.