

HOUSE BILL REPORT

HB 2770

As Reported by House Committee On:

Insurance, Financial Services & Consumer Protection

Title: An act relating to homeownership security, responsible mortgage lending, and improving protections for residential mortgage loan consumers.

Brief Description: Enacting the governor's homeownership security task force recommendations regarding responsible mortgage lending and homeownership.

Sponsors: Representatives Kenney, Lantz, Upthegrove, Conway, Morrell, Schual-Berke, McIntire, Hudgins, Simpson and Rolfes; by request of Governor Gregoire.

Brief History:

Committee Activity:

Insurance, Financial Services & Consumer Protection: 1/22/08, 1/29/08 [DPS].

Brief Summary of Substitute Bill

- Requires additional disclosure to mortgage borrowers.
- Prohibits prepayment penalties that extend beyond 60 days prior to the initial reset of an adjustable rate mortgage in residential loans.
- Prohibits negative amortization for a borrower in residential loans.
- Prohibits the steering of consumers into higher cost loans.
- Establishes the framework and penalties for crimes related to mortgage fraud.

HOUSE COMMITTEE ON INSURANCE, FINANCIAL SERVICES & CONSUMER PROTECTION

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 8 members: Representatives Kirby, Chair; Kelley, Vice Chair; Roach, Ranking Minority Member; Hurst, Loomis, Santos, Simpson and Smith.

Staff: Jon Hedegard (786-7127).

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.

Background:

Regulation of Financial Institutions

Financial institutions are regulated in accordance with their charters. A financial institution may be chartered in Washington, a different state, or the federal government. An institution that is chartered in Washington is subject to the regulatory authority of the Department of Financial Institutions (DFI).

State and Federal Issuances on Mortgage Lending

In October 2006 federal financial regulators published the final *Guidance on Nontraditional Mortgage Product Risks (Guidance)*. "Nontraditional" mortgage products include interest-only mortgages, payment option adjustable rate mortgages, and other products that have negative amortization (certain products that result in monthly payments where the payment is insufficient to cover the interest due on the loan). The National Associations for State Financial Regulators adopted parallel standards to address state-licensed mortgage entities that are not subject to the federal guidance.

In June 2007 federal financial regulators published the final *Statement on Subprime Mortgage Lending (Statement)*. The *Statement* addresses the use of hybrid adjustable rate 30-year mortgages that have low rates for a two- or three-year period before adjusting for 27- or 28-year period. The National Associations for State Financial Regulators adopted parallel standards to address state-licensed mortgage entities that are not subject to the federal statement.

Mortgage Broker Licensing

The DFI licenses mortgage brokers and loan originators under the Mortgage Broker Practices Act (MBPA). The MBPA has provisions regarding licensing, continuing education, prohibited practices, examinations, investigations, and criminal, civil, and administrative penalties.

Foreclosure on Mortgages and Deeds of Trust

Mortgages and deeds of trust are two forms of security interest in real property used for real estate financing. A mortgage is a pledge of real property as security for a debt owed to the debtor. A mortgage creates a lien on the real property. A mortgage may be foreclosed only through a judicial proceeding according to detailed statutory requirements and procedures.

A deed of trust is, in essence, a three-party mortgage. The borrower grants a deed creating a lien on the real property to a third party (the trustee) who holds the deed in trust as security for an obligation due to the lender. The deed of trust transfers title to the borrower, yet the trustee has a lien against the property until the borrower pays off the obligation in full. If the borrower defaults on the obligation, a deed of trust may be foreclosed without a judicial proceeding. The trustee may foreclose on the property by conducting a public trustee sale when the required procedural and notice requirements are met. The trustee must provide notice to the borrower 30 days prior to the recording of a notice of sale. At least 90 days prior to a sale, the trustee must record a notice of sale in the office of the auditor in the county where the property is located.

Criminal Profiteering

In 1985 the Legislature passed laws regarding "criminal profiteering." These laws are similar to the federal Racketeering Influenced and Corrupt Organizations (RICO) Act. Criminal profiteering involves the commission of a crime listed in the statute for financial gain. Crimes that are included in the statute are: violent felonies and felonies associated with gambling, drugs, pornography, prostitution, extortion, identity theft, insurance fraud, and securities fraud. There are criminal penalties and civil remedies for criminal profiteering. The civil remedies include monetary penalties, injunctive remedies, and forfeiture.

In September 2007 Governor Gregoire established the Task Force for Homeowner Security (Task Force) to evaluate instability in the mortgage market and minimize the impact in Washington. The Task Force met six times between September and mid-December and issued a report on December 21, 2007. The report included approximately 24 recommendations, including:

- improving disclosure;
- notice to homeowners facing potential foreclosure;
- adoption of the federal guidance and statement by rule by the DFI;
- prohibiting the steering of consumers into higher cost loans;
- limiting prepayment penalties;
- prohibiting certain products that result in negative amortization;
- clarifying the duty a mortgage broker owes to a customer; and
- increasing the penalties for mortgage fraud.

Summary of Substitute Bill:

A number of definitions are provided. "Financial institution" is defined to include: state chartered banks, consumer loan companies, credit unions, mutual savings banks, savings and loans, and mortgage brokers.

Disclosure

The DFI must adopt a disclosure summary understandable to the average person that includes:

- the fees and discount points on the loan;
- the interest rate of the loan;
- the broker's yield spread premium;
- the presence of any prepayment penalties;
- the presence of a balloon payment;
- whether or not property taxes and property insurance is escrowed; and
- other key terms and conditions of the loan.

A residential mortgage loan may not be made unless the summary is provided by a financial institution to a borrower within three days of a loan application. If the terms of the loan change, a new summary must be provided to the borrower within three days of the change or at least three days before closing, whichever is earlier.

State and Federal Issuances on Mortgage Lending

The DFI must adopt rules and apply the *Guidance* and *Statement* to financial institutions. The financial institutions must adopt and adhere to policies that are reasonably intended to achieve the objectives in the *Guidance* and *Statement*.

Prepayment Penalties

A financial institution may not make or facilitate the origination of a residential mortgage loan that includes a prepayment penalty that extends beyond 60 days prior to the initial reset of an adjustable rate mortgage.

Negative Amortization

A financial institution may not make or facilitate the origination of a residential mortgage loan that is subject to the *Guidance* and *Statement* if the loan includes any provisions that result in negative amortization for a borrower.

Steering

A person subject to licensing under the MBPA or the Consumer Loan Act may not steer, counsel, or direct any potential borrower to accept a residential mortgage loan with a risk grade less favorable than what the borrower would qualify under the lender's existing underwriting standards. The licensee must prudently apply the underwriting standards to the information provided by the borrower.

Rules

The DFI is given general authority to adopt rules.

Mortgage Fraud

In the lending process, it is a Class B felony to:

- defraud or mislead any borrower, lender, or person;
- engage in deceptive practices;
- obtain any property by fraud or misrepresentation;
- knowingly make, use, or facilitate a misstatement, misrepresentation, or omission knowing that it may be relied on by another; and
- receive anything of value in connection with a closing that resulted from a fraudulent practice.

A knowing violation or knowingly aiding or abetting a violation is "ranked" on the sentencing grid in the III tier. This places it on a level that gets a sentence ranging from one to three months up to five years in prison.

Mortgage fraud is added to the list of felonies that are subject to the criminal profiteering laws.

Any person who knowingly alters, destroys, or conceals information to impair the investigation of mortgage fraud is guilty of a class B felony.

Examinations, Investigations, and Enforcement

The DFI has the authority to investigate or examine mortgage brokers, state-chartered banks, state-licensed consumer loan companies, state-chartered credit unions, state-chartered mutual

savings banks, and state-chartered savings and loans to enforce applicable provisions of the MBPA.

Duties of Mortgage Brokers

Mortgage brokers, loan originators, and people working with or for mortgage brokers must:

- be actuated by good faith;
- abstain from deception; and
- practice honesty and equity in all matters related to their profession.

Notice of Foreclosure On a Deed of Trust

If the property is owner-occupied residential property, the notice must include a statement that provides some specific information for the homeowner to consider about the foreclosure and the possible options the homeowner may have available to them, including low-cost or free counseling and legal help.

Substitute Bill Compared to Original Bill:

A number of changes to the definitions are made. A definition of "adjustable rate mortgage" or "ARM" definition is added. The definition of "borrower" is modified. The definition of "negative amortization" is modified. The definition of "residential mortgage loan" is modified. "Single family dwelling" language is modified. The disclosure of yield spread premium is modified to add "as a dollar amount." A new disclosure component is added – whether there is price added because a loan has reduced documentation. A grant of rule-making authority to the DFI is limited to residential mortgage loans. The provision regarding the residential mortgage loans with negative amortization provisions is limited to loans that are subject to the *Guidance* or *Statement*. The steering provisions are limited to "residential mortgage loans." In the authority for the DFI to adopt rules to implement the chapter, a provision is added where the DFI may identify which parts of this act apply to open-ended lines of credit. In the criminal provisions, the word "deliberate" is struck and the words "negligent" and "knowingly" are added. A number of language and grammatical changes are made to the bill.

Appropriation: None.

Fiscal Note: Aavailable.

Effective Date of Substitute Bill: The bill takes effect 90 days after adjournment of session in which bill is passed.

Staff Summary of Public Testimony:

(In support) Homeownership is an important path to build wealth. Home building is an important aspect of our economy. In recent years, many lenders lessened their standards and provided new and exotic loans and product features. Some of those products included 100 percent financing, interest-only loans, and loans with low introductory rates and adjustable terms. These practices helped lead to the current national crisis. Washington has not been hit

as hard as other areas but the default and foreclosure rates in the state are rising. The United States Congress may act and address some of these issues but the Legislature also has a duty to advocate for homeowners in Washington. A bill should help all homeowners. In the bill, there must be a requirement that mortgage brokers act in the interest of the borrowers and act in the utmost good faith. A ban or limitation on flipping loans is needed. The current lending practices have lead to lost wealth, suffering, and homelessness.

There are some technical issues in the bill that were a result of the compressed time-lines associated with the Task Force. In some areas, the language may be drafted slightly more broadly than the Task Force recommendation it was intended to implement. The disclosure summary provisions will help people understand their loan terms. Most people do not read all of their loan documents. The bill prohibits steering. Many borrowers who could have qualified for a prime loan ended up with a subprime loan. In some cases, that was an informed choice by the borrower. Other times, it may have been due to steering by a mortgage broker. The bill limits negative amortization where the borrower can end up owing more than the amount of the loan. There are criminal penalties in the bill. There is currently a Mortgage Broker Fraud Account to help us fight mortgage fraud. These increased penalties are another tool in that fight.

The Task Force was a broad, diverse group that agreed to 24 recommendations. This bill could codify many of those recommendations into law. The technical changes that would better reflect the Task Force's recommendations will also be supported by Task Force members. All of these recommendations were agreed to by all members of the Task Force. There is a duty of good faith for mortgage brokers in the bill. There was a minority report by the Task Force that preferred a fiduciary duty.

The Task Force had a thoughtful process and developed recommendations that will protect consumers. There are some technical challenges in the current draft of the bill that are being worked on for a proposed substitute. Those changes will better conform the bill to the Task Force recommendations and ensure that the bill can be fully implemented. There is always a concern that Washington-based financial institutions will be placed at a disadvantage because the Legislature has more authority to regulate those entities than other financial institutions. This bill does not place those Washington financial institutions at a disadvantage.

This bill will help address abuses in the subprime market. A disproportionate amount of those impacts fall on poor and minority members of the community. There are some ways the bill could be strengthened. First, the lenders and brokers should be required to use sound underwriting. They should have to verify income. Property insurance and taxes should be escrowed. Second, there should be a ban on loan flipping. Third, the prepayment penalties should be strengthened. A ban is the best option. At a minimum, the time-frame prior to the initial reset period should be increased. Fourth, the duty of the mortgage broker to the borrower should be increased to a fiduciary duty. Mortgage brokers make 70 percent of the subprime loans. They are not currently required to work in the borrower's best interest. All four of these suggestions have broad community support. The bill is a good start. Some provisions should be strengthened. Subprime lending is the reason for the current lending crisis. This state is starting to see the impacts and problems associated with the national

crisis. The problem is not subprime loans or borrowers. The problem is the practices of the lenders. One major issue is disclosure. There is often inadequate disclosure, incorrect disclosure, or outright deception. The underwriting rules were not relaxed in the lending boom, they were ignored. A fiduciary duty upon mortgage brokers would solve many of the problems in the market. People expect that a mortgage broker is working in their best interest and rely on the experience of that broker. The Task Force members support the technical changes to the underlying bill.

(Opposed) None.

Persons Testifying: Representative Kenney, prime sponsor; Deb Bortner, Department of Financial Institutions; Kim Herman, Washington State Housing Finance Commission; Denny Eliason, Washington Bankers Association; Brad Tower, Community Bankers of Washington; Greg Pierce, Washington Financial League; Gary Gardner, Boeing Employees Credit Union; Kim Justice, Statewide Poverty Action Network; Tony Brooks, Association of Community Organizations for Reform Now; Ari Brown, Brown Sayre Law Group; and Steve Buckner, Washington Association of Mortgage Brokers.

Persons Signed In To Testify But Not Testifying: None.