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PREVENTING PREDATORY LENDING IN THE CALIFORNIA SUBPRIME MORTGAGE MARKET

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Examining the origins of the California subprime mortgage crisis, this Note attempts to explain why California legislation failed to deter predatory lending practices in the subprime mortgage market. Specifically, California Financial Code Division 1.6, which was enacted in 2001 to prevent the proliferation of unjust mortgage loans, contains several fundamental flaws. Although California chaptered Senate Bill 385 into law in 2007 to increase oversight of the subprime mortgage market, this legislation is insufficient to curb predatory lending practices. To address the hazards of inadequate underwriting standards, yield spread premiums, standardized disclosure, and reduced-documentation loans, this Note proposes a six-part legislative solution to the predatory lending problem.

I. INTRODUCTION

Predatory lending has contributed significantly to the collapse of the subprime mortgage market in California.[1] In 2001, California enacted Financial Code Division 1.6 to deter predatory practices in subprime lending.[2] Unfortunately, this legislation has proven to be insufficient to prevent the proliferation of unjust loans.[3] Recognizing the need for greater regulation, the California Senate in February 2007 introduced Bill 385 to further address the predatory lending issue.[4] This bill was chaptered into law in October 2007.[5] The provisions of Bill 385, however, are vague and incomplete.

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1. *See infra* Part II.
2. Am. Fin. Servs. Ass'n v. City of Oakland, 104 P.3d 813, 815 (Cal. 2005).
3. *See infra* Part V.
4. S.B. 385, S. 2007–2008, Reg. Sess. (Cal. 2007).

This Note presents a potential solution to the problem of predatory lending in California. Part II of this Note illustrates the origins of the subprime mortgage crisis in California. Part III explains why Division 1.6 failed to create protections that could have prevented the crisis. Part IV explains why Senate Bill 385 will also fail to cure the predatory lending problem. Part V proposes a six-part legislative solution, designed to thwart the most prevalent predatory lending practices by addressing the flaws of Division 1.6 and Senate Bill 385.

II. OVERVIEW OF THE CALIFORNIA SUBPRIME MORTGAGE CRISIS

A. What is a Subprime Mortgage?

Subprime lending refers to the extension of credit to persons who are considered to be high-risk borrowers.[6] For example, subprime borrowers tend to possess one or more of the following risk characteristics: recent payment delinquency or bankruptcy, a low credit score, or a high debt-to-income ratio.[7] Conversely, a "prime" borrower usually does not possess any of these risk characteristics.[8] A subprime mortgage is simply a mortgage loan made to a subprime borrower.[9] Lenders are willing to take on the additional risk accompanying a subprime borrower because they offset their risk by charging higher interest.[10]

B. Why Did the Subprime Mortgage Market Collapse?

Due to various economic factors, including low interest rates, rapid home price appreciation, and strong investor demand for

5. *Id.*

6. *See* Ronald G. Isaac, Prepared Statement of the Federal Trade Commission Before the California State Assembly Committee on Banking and Finance on Predatory Lending Practices in the Home-Equity Lending Market (Feb. 21, 2001), *available at* http://www.ftc.gov/be/v010002.shtm.

7. Press Release, Office of the Comptroller of the Currency et al., Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001), *available at* http://www.fdic.gov/news/news/press/2001/pr0901a.html.

8. *See id.*

9. *See id.*

10. *See* Yulia Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, SOC. SCI. RESEARCH NET. 4 (Dec. 5, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396.

mortgage-based securities, the subprime mortgage market grew dramatically over the last several years.[11] Between 2003 and 2005, the subprime share of all original mortgage loans increased from 7.9 percent to approximately 20 percent.[12] Unfortunately, during the same period, the foreclosure rate on subprime loans doubled from 9.8 percent to 19.4 percent.[13] These figures suggest that while the total number of subprime loans was growing, many of these loans were issued to borrowers who could not afford to repay their debt.

The expansion of the subprime market over the last half-decade was primarily driven by the growth of intermediaries between the borrower and the lender.[14] These intermediaries, including loan originators such as mortgage brokers and mortgage companies, had a strong incentive to increase the supply of subprime loans.[15] Unfortunately, the intermediaries also had little incentive to ensure that the loans were affordable. In 2006, approximately two-thirds of all subprime loans were originated by mortgage brokers.[16] A mortgage broker is a mortgage salesperson who markets to prospective borrowers, assesses borrower credit, and submits loan applications to lenders on the borrower's behalf.[17] Mortgage brokers are chiefly concerned with moving a given transaction to closing, upon which the broker receives a commission from the lender.[18] Brokers have little interest in originating loans that are fair or

11. *See Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Institutions: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Serv.*, 110th Cong. 69–70 (2007) (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation).

12. Inside Mortgage Finance, http://www.imfpubs.com (last visited Oct. 18, 2008).

13. *See* ELLEN SCHLOEMER ET AL., LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS 16 (2006), *available at* http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf.

14. *See* CHARLES E. SCHUMER & CAROLYN B. MALONEY, THE SUBPRIME LENDING CRISIS: THE ECONOMIC IMPACT ON WEALTH, PROPERTY VALUES AND TAX REVENUES, AND HOW WE GOT HERE 17 (2007), *available at* http://www.minnpost.com/client_files/pdfs/102507OctoberSubprimeReport.pdf.

15. *Id.*

16. SCHLOEMER ET AL., *supra* note 13, at 24.

17. *See id.* at 28.

18. *See id.*

favorable to the borrower.[19] In fact, the more expensive the loan, the higher the broker's commission.[20]

Mortgage companies were another major lending channel.[21] Because mortgage companies are not deposit-taking institutions, they are not subject to the safety and soundness regulations that govern federal or state banks.[22] Once a mortgage company obtains a corporate license from the state, any employee of the corporation can originate a loan, without any training or education prerequisites.[23] An employee who originates loans under the company's umbrella license is typically called a loan officer. The officer has essentially the same incentive as a mortgage broker: to maximize commissions by originating as many expensive loans as possible.

While lenders had strong incentives to make predatory or questionable loans, certain elements limited their incentive to originate affordable loans. For example, lenders typically held onto only a fraction of the loans they made in their own portfolios.[24] Instead, they aggregated and sold the majority of the loans to secondary markets as asset-backed securities.[25] Rather than receiving revenue from individual mortgage payments in due course, selling packaged loan securities allowed lenders to generate full returns instantly. In this scheme, the lender's strongest incentive was to close the loan, sell it immediately for profit, and make more loans to repeat the cycle.

The securities firms that purchased the loans from the lenders also cared little about the affordability of each loan. Since each loan was pooled with thousands of other loans and sold as a security to investors, most of the risk was distributed to the investment community.[26] Because of the strong home value appreciation during

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19. *See id.* at 29.

20. Brokers receive a bonus from the lender for originating a higher-priced loan. This bonus is called the Yield Spread Premium (YSP). For more on YSPs, see *infra* Part III.B.

21. SCHUMER & MALONEY, *supra* note 14, at 17.

22. *Id.* at 18.

23. CAL. ASS'N OF MORTGAGE BROKERS, CREATING THE HIGHEST STANDARDS OF CONSUMER PROTECTION IN THE MORTGAGE INDUSTRY: AN ACTION PLAN FOR THE MORTGAGE INDUSTRY, REGULATORS AND CONSUMERS 4 (2006).

24. SCHUMER & MALONEY, *supra* note 14, at 18.

25. *Id.*

26. *See* Josh Clark, How Can Mortgage-backed Securities Bring Down the U.S. Economy?, HOW STUFF WORKS, Sept. 29, 2008, http://www.howstuffworks.com/mortgage-backed-security.htm.

this period, borrowers who faced financial difficulties could resolve their problems temporarily by refinancing their respective mortgages.[27] Refinancing masked the immediate losses from defaulting loans, and as a result, investor demand for subprime asset-based securities remained strong.[28] Overall, there was an ample supply of credit, combined with little motivation for any participant in the lending channel to ensure the affordability of each individual loan.

The increase in the supply of subprime credit coincided with an increase in consumer demand for such credit. From 2001 to 2004, the Federal Reserve cut interest rates thirteen times in response to the recession, the dot-com collapse, and the September 11 terrorist attacks.[29] With reduced rates, housing became far more affordable for new homebuyers. Meanwhile, housing prices appreciated at historic rates from 2001 to 2005.[30] In response, many homeowners extracted the increased equity in their home to fund their consumer debts.[31] In 2003, approximately twelve million mortgage loans were refinanced into new mortgages.[32]

As competition increased in the subprime market, lenders looked for new ways to increase the volume of subprime mortgages. When underwriting standards continued to decline, predatory lending practices became more prevalent. Lenders focused on promoting adjustable rate mortgages ("ARM"), where borrowers were qualified for loans under a low initial "teaser" rate, even though the interest rate thereafter adjusted periodically based on a market index.[33]

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27. *See* Allan K. Krinsman, *Subprime Mortgage Meltdown: How Did It Happen and How Will It End?*, 13 J. STRUCTURED FIN. 1 (2007).

28. *Id.* at 2.

29. Bankrate.com, 2001–2004 Key Interest Rate Moves, http://www.bankrate.com/brm/news/fed/20010627e.asp?prodtype=mtg&thisponsor=fed (last visited Nov. 15, 2008).

30. SCHUMER & MALONEY, *supra* note 14, at 3.

31. Extracting equity from a home can be accomplished either with a home-equity loan or a cash-out refinance. In a home equity loan, the homeowner borrows against the equity in their home. *See* Vikas Bajaj, *Equity Loans As Next Round in Credit Crisis*, N.Y. TIMES, Mar. 27, 2008, at C2. In a cash-out refinance, the homeowner refinances for a mortgage larger than the balance due on the home, with the excess "cashed-out" to the homeowner. *See* FHA.com, FHA Refinance and Cash Out Options for Homeowners, http://www.fha.com/refinance.cfm (last visited Nov. 15, 2008).

32. *See* Margaret M. McConnell et al., *After the Refinancing Boom: Will Consumers Scale Back Their Spending?*, CURRENT ISSUES ECON. & FIN., Dec. 2003, at 1.

33. An adjustable rate mortgage charges a discounted rate for an initial period of time, after which the rate adjusts to reflect a market index. *See* FED. RESERVE BD., CONSUMER HANDBOOK

Although these mortgages are not predatory per se, federal agencies have recognized the heightened risks that these products present to subprime borrowers.[34] In addition, during the same period, stated income loans, which do not require borrowers to have their incomes verified, became more widely available.[35] As these developments continued to expand the subprime market, the total amount of subprime loans grew from $190 billion in 2001 to $625 billion in 2006.[36] However, the proliferation of unaffordable loans would soon bring dire consequences.

By 2007, the number of defaults on subprime loans reached a crisis point.[37] As home price appreciation slowed and interest rates began to rise, homeowners could no longer afford to borrow against their home's equity. Borrowers who had obtained adjustable rate mortgages were faced with severe payment shock when the teaser rate expired.[38] As foreclosures increased, the supply of homes increased, putting more downward pressure on home prices.[39] In addition to the overall supply and demand problem, foreclosures affected nearby property values in hard-hit areas.[40] The decrease in property values also limited what the lenders could recover from foreclosing on borrowers' properties.

Eventually, the subprime mortgage industry collapsed.[41] In April 2007, the nation's second-largest subprime mortgage provider,

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ON ADJUSTIBLE RATE MORTGAGES 1 (2006). For example, a 2/28 ARM charges a low, fixed "teaser" rate for the first two years and then the interest rate adjusts periodically over the next twenty-eight years. It is a predatory practice for loan originators to attract borrowers using the deceptively low teaser rate while disguising significant payment increases that occur later on. Kurt Eggert, *Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 516 (2002).

34. Proposed Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10533–01 (Mar. 8, 2007).

35. Krinsman, *supra* note 27, at 4.

36. SCHUMER & MALONEY, *supra* note 14, at 10.

37. Krishna Guha, *Greenspan Alert on U.S. House Prices*, FIN. TIMES, Sept. 16, 2007, at 1.

38. Payment shock occurs when a large increase in the scheduled payments of a mortgage surprises the borrower. BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., INTEREST-ONLY MORTGAGE PAYMENTS AND PAYMENT-OPTION ARMS—ARE THEY FOR YOU? 1 (2006). When interest rates rise, the payments on an ARM rise accordingly. *Id.* at 12.

39. SCHUMER & MALONEY, *supra* note 14, at 6.

40. Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL'Y DEBATE 57, 57 (2006).

41. Bob Tedeschi, *Ripples from the Supbrime Storm*, N.Y. TIMES, Mar. 25, 2007, § 11 (Real Estate Desk) at 13.

New Century Financial, filed for Chapter 11 Bankruptcy protection.[42] The nation's largest mortgage lender, Countrywide Financial Corporation, saw its stock price fall dramatically.[43] From January 3, 2007 to February 4, 2008, Countrywide's share price dropped from $42.11 to $7.22.[44]

Although the fallout from the collapse is not finalized, one anticipated result is that investors will demand a higher rate of return for investing in the subprime mortgage market, due to their new perception of risk.[45] Consequently, future subprime borrowers will face higher interest costs, increasing the price of home ownership.

C. *Why is Predatory Lending Particularly Prevalent in the Subprime Mortgage Industry?*

Predatory lending has contributed strongly to the subprime market crisis. It has led many families to lose their homes to foreclosures, and it will prevent future homebuyers from accessing credit at a reasonable price. Neither lenders nor borrowers will benefit if predatory lending practices are allowed to continue.

The characteristics of the typical subprime borrower place him or her in a weak bargaining position for at least three reasons. First, subprime borrowers usually have experienced previous difficulties in obtaining credit, leading them to underestimate their ability to obtain new sources of credit.[46] Second, subprime borrowers tend to reside in low-income and minority communities, which are comparatively underserved by traditional prime lenders such as national banks.[47] The lack of sufficient competition among lenders limits borrowers'

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42. Jonathan Stempel, *New Century Files for Chapter 11 Bankruptcy*, REUTERS NEWS, Apr. 2, 2007.

43. Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N. Y. TIMES, Aug. 26, 2007, § 3 (Financial Desk) at 1.

44. MSN Money, http://money.msn.com/ (type in "CFC", then select dates and push the "get prices" button).

45. Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp., Turmoil in the U.S. Credit Markets: Examining Recent Regulatory Responses to the Committee on Banking, Housing and Urban Affairs (Oct. 23, 2008) (transcript available at http://www.fdic.gov/news/news/speeches/chairman/spoct2308.html).

46. U.S. DEP'T OF HOUS. & URBAN DEV. & U.S. DEP'T OF TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING 18 (2000), *available at* http://www.huduser.org/Publications/pdf/treasrpt.pdf [hereinafter HUD-TREASURY REPORT].

47. For an explanation of why banks have fled inner-city neighborhoods, see Gregory Squires, *Forgoing a Tradition of Redlining for a Future of Reinvestment*, 15 BUS. J. SERV. GREATER MILWAUKEE 50 (1998).

ability to bargain and shop for more favorable loan terms.[48] Third, the subprime mortgage companies who dominate mortgage lending in low-income and minority neighborhoods are not subject to the same oversight as their prime market counterparts, such as federally supervised banks.[49] These three factors help make the subprime mortgage market particularly susceptible to predatory lending practices.

D. Why is the Subprime Mortgage Crisis Particularly Problematic in California?

Due to various economic and demographic factors, predatory lending is particularly troubling in California's subprime mortgage market. From an economic standpoint, the impending foreclosure rate increases will be felt most acutely in states with previously strong housing appreciation, such as California.[50] California is expected to have the greatest number of foreclosures among all states.[51] Of the fifteen metropolitan areas in the country with the highest projected foreclosure rates, nine are in located in California.[52]

From a demographic perspective, significant concentrations of African Americans and Latinos in California make the state particularly susceptible to predatory lending practices. Research has shown that African Americans and Latinos are more likely to become subprime borrowers than Caucasians or Asian Americans.[53] One major reason is that African Americans and Latinos are more likely to be rejected in their applications for prime loans.[54] According to U.S. Census Bureau figures released in 2005, California had the fifth largest African American population in the country.[55] In addition, in 2006, 35.9 percent of Californians were persons of Hispanic or Latino descent, compared to a national

48. HUD-TREASURY REPORT, *supra* note 46, at 18.

49. *Id.*

50. SCHLOEMER ET AL., *supra* note 13, at 17.

51. SCHUMER & MALONEY, *supra* note 14, at 12.

52. SCHLOEMER ET AL., *supra* note 13, at 20.

53. ALLEN J. FISHBEIN & PATRICK WOODALL, SUBPRIME LOCATIONS: PATTERNS OF GEOGRAPHIC DISPARITY IN SUBPRIME LENDING 4 (2006).

54. *Id.* at 9.

55. U.S. CENSUS BUREAU, U.S. DEP'T OF COMMERCE, STATE RANKINGS: STATISTICAL ABSTRACT OF THE UNITED STATES 24 (2005), *available at* http://www.census.gov/prod/2004pubs/04statab/pop.pdf.

average of 14.8 percent.[56] These demographic factors indicate a particular need for California to protect its citizens from abusive practices.

E. How Has California Attempted to Address the Crisis?

In 2001, the California legislature enacted a set of statutes, collectively referred to as "Division 1.6," to combat predatory lending practices that typically occur in the subprime home mortgage market.[57] The statutes are applicable to state-chartered financial institutions and state-licensed brokers.[58] They are codified in the California Financial Code under sections 4970–4979.8.[59]

In an effort to further strengthen regulations in this area, California State Senator Michael Machado introduced Senate Bill 385 in February 2007.[60] The bill officially became law on October 5, 2007.[61]

Although California has made a clear legislative effort to address predatory lending in the subprime market, there are significant flaws in the provisions of Division 1.6 and Senate Bill 385. The next two sections analyze why these statutes fail to prevent predatory lending in the subprime mortgage market.

III. WHY CALIFORNIA FINANCIAL CODE DIVISION 1.6 HAS FAILED TO PREVENT PREDATORY LENDING PRACTICES

A. Overview of Division 1.6

Division 1.6 applies to all loans secured by real property.[62] The two most significant provisions in Division 1.6 are section 4970 and section 4973. Section 4970 contains definitions for terms used throughout Division 1.6,[63] while section 4973 lists prohibited acts

56. U.S. Census Bureau, U.S., California QuickFacts, http://quickfacts.census.gov/qfd/states/06000.html (last visited Nov. 15, 2008).

57. Am. Fin. Servs. Ass'n v. City of Oakland, 104 P.3d 815, 815 (Cal. 2005).

58. In California, most individual mortgage brokers are licensed through the Department of Real Estate, while mortgage companies obtain corporate licenses from the Department of Corporations. *See* CAL. FIN. CODE § 4970(g) (Deering 2007).

59. *Id.* §§ 4970–4979.8.

60. S.B. 385, S. 2007–2008 Reg. Sess. (Cal. 2007).

61. *Id.*

62. CAL. FIN. CODE §§ 4970–4979.8 (Deering 2007)

63. *Id.* § 4970.

and limitations for loans that qualify as a "covered loan" under section 4970.[64] In short, Division 1.6 only offers protection to a subprime borrower if the subprime loan she acquired fits under the section 4970 definition of a "covered loan."[65]

In order to qualify as a covered loan, the loan must first meet certain distinct criteria. First, the loan must be a consumer loan in which the original principal balance of the loan does not exceed $417,000.[66] Second, if the loan is a mortgage, it must meet at least one of two conditions: (A) The annual percentage rate[67] at consummation of the transaction is more than eight percentage points greater than the yield on Treasury securities having a comparable period of maturity;[68] or (B) the total points[69] and fees payable by the consumer at or before closing of the mortgage will exceed 6 percent of the total loan amount.[70] If neither condition is met, the loan is not subject to the protections of Division 1.6.

To appreciate the conditions set out above, imagine a hypothetical subprime borrower named Bob. Suppose Bob obtains a thirty-year subprime mortgage worth $200,000. The mortgage has satisfied the first condition of a covered loan, because it is a consumer loan[71] and because the loan is less than $417,000. Now, suppose the yield on a thirty-year Treasury bond is 4.5 percent.[72] In order to satisfy the second condition of a covered loan, one of two facts must be true. Either the mortgage must have an annual percentage rate greater than 12.5 percent, since this is eight percentage points higher than the Treasury bond yield, or the

64. *Id.* § 4973.

65. *Id.* § 4970.

66. *Id.* § 4970(b).

67. The annual percentage rate ("APR") is the total cost of credit for one year, expressed as a percentage of the loan's total remaining unpaid balance at the beginning of a given year. Federal Reserve Bank of New York, Interest Rates: An Introduction, http://www.ny.frb.org/education/define.html#aps (last visited October 31, 2008).

68. CAL. FIN. CODE § 4970(b) (1) (Deering 2007).

69. Points are a one-time fee the borrower pays to lower the interest rate. *See id.* § 4970(c).

70. *Id.* § 4970(b)(2).

71. A consumer loan is defined as a "consumer credit transaction that is secured by real property located in" California, and "intended to be" the consumer's principal dwelling. *Id.* § 4970(d).

72. For historical data regarding Treasury bond rates, see U.S. Department of Treasury, Interest Rate Statistics, http://www.treas.gov/offices/domestic-finance/debt-management/interest-rate/yield_historical_main.shtml.

mortgage must have points and fees exceeding 6 percent of $200,000, or $12,000. Evidently, a loan must be fairly expensive in order to qualify for the protections of Division 1.6.

If a loan does qualify as a covered loan, it is subject to a list of limitations set out in section 4973. There are several notable limitations. First, section 4973(l)(2) states that a person who originates a loan "shall not steer, counsel, or direct any prospective consumer to accept a loan product at a higher cost than that for which the consumer could qualify."[73] Second, under section 4973(f)(1), the loan originator must reasonably believe that the borrower will be able to make the scheduled repayments.[74] Specifically, the statute presumes the consumer will be able to make the scheduled payments if, when the loan is consummated, the borrower's monthly debts do not exceed 55 percent of his or her monthly gross income.[75] Third, section 4973(c) restricts the use of negative amortization,[76] except in the case of first mortgages.[77] As discussed below, each of the above prohibitions contains flaws that prevent them from reducing predatory lending.

B. Problem I. Yield Spread Premiums

A yield spread premium ("YSP") is a cash bonus that the mortgage broker receives from the lender for placing the borrower in a loan with a higher interest rate than the minimum accepted by the lender.[78] Because of YSPs, brokers have a strong incentive to steer borrowers to higher-interest loans, even though they could have qualified for cheaper loans.[79] A borrower may be completely unaware that she qualifies for a better interest rate. As stated above, California Financial Code section 4973(l)(2) specifically prohibits a

73. CAL. FIN. CODE § 4973(l)(2) (Deering 2007).

74. *Id.* § 4973(f)(1).

75. *Id.*

76. Negative amortization occurs when the outstanding principal on a loan increases because the monthly payment(s) do not cover the monthly interest. John C. Dugan, Comptroller of the Currency, Remarks Before the Consumer Federation of America 1 (December 1, 2005) (transcript available at http://www.occ.treas.gov/ftp/release/2005-117a.pdf).

77. CAL. FIN. CODE § 4973(c) (Deering 2007).

78. CENTER FOR RESPONSIBLE LENDING, YIELD SPREAD PREMIUMS: A POWERFUL INCENTIVE FOR EQUITY THEFT, CRL ISSUE BRIEF NO. 11, at 1 [hereinafter RESPONSIBLE LENDING].

79. *Id.*

loan originator from steering a prospective customer to a loan with a higher cost if the customer could qualify for a cheaper loan.[80] But because this prohibition applies only to "covered loans" under section 4970, it fails to address the abusive use of YSPs.

In *Wolski v. Fremont Investment and Loan*,[81] the California Court of Appeal held that a YSP cannot be construed as a fee payable "at or before closing."[82] Therefore, YSPs are not considered to be "points and fees" under section 4970 because this statute regulates only points and fees payable "at or before closing."[83] In short, even if a loan originator receives an unnecessary YSP, the borrower is not protected by section 4973 if the points and fees on her loan are less than 6 percent and the APR is not more than 8 percent greater than the interest on a similar-maturity Treasury bond.

Referring back to hypothetical borrower Bob,[84] suppose Bob is unaware that he can qualify for a loan with an interest rate as low as 8.5 percent. If the loan originator places Bob into a loan with a 10.5 percent interest rate, the loan originator will receive a YSP bonus from the lender because the lender will receive an extra 2 percent of interest over the life of Bob's loan. Bob's loan will not be regulated by section 4973(l)(2) as long as the APR on his loan is not 8 percent higher than the Treasury bond rate. So, the loan originator can legally steer Bob into a higher-priced loan even though this is precisely the predatory practice section 4973(l)(2) sought to prevent.

There are two significant consumer protection problems when YSPs are used in the subprime mortgage market. First, when a loan originator charges a YSP, equity is stolen from the borrower. Since the borrower was entitled to a lower interest rate, when she takes a higher-priced loan offered by the loan originator she will ultimately pay more interest over the life of the loan than is necessary.[85] This scenario is particularly problematic when the loan originator targets unsophisticated borrowers who do not understand their options.[86]

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80. *See supra* Part III.A.

81. 25 Cal. Rptr. 3d 500 (Ct. App. 2005).

82. *Id.* at 503.

83. CAL. FIN. CODE § 4970(b)(2) (Deering 2007).

84. *See supra* Part III.A.

85. *See* KEITH ERNST ET AL., STEERED WRONG: BROKERS, BORROWERS, AND SUBPRIME LOANS 5 (2008), *available at* http://www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf [hereinafter ERNST, STEERED WRONG].

86. *See id.* at 7.

Second, YSPs motivate the lender to charge a prepayment penalty. In most cases, lenders pay the YSP bonus to the broker at the start of the loan.[87] They are willing to do so only because they will recover the cost of the bonus from the additional interest payments the borrower pays over the life of the loan.[88] If the borrower were to pay off the loan early, however, the lender would not recover the cost of the YSP bonus it paid to the broker.[89] Thus, YSPs give the lender incentive to impose a prepayment penalty to guarantee that the lender will recover the YSP bonus if the borrower repays the loan early.[90]

There are two reasons why prepayment penalties should be discouraged. First, despite popular perception to the contrary, studies have shown that prepayment penalties do not confer interest rate benefits to borrowers.[91] Second, prepayment penalties steal home equity from a borrower, just like YSPs. When a subprime borrower improves his credit and attempts to refinance to obtain a less-costly loan, the prepayment penalty is generally financed into the new loan, functioning as an additional and expensive fee.[92]

In summary, YSPs increase the overall price of a loan and cause lenders to penalize borrowers for refinancing. Although the court in *Wolski* realized that YSPs were "considered by some to be a predatory lending practice,"[93] it left the remedy to the legislature. Those in favor of YSPs point out that the use of YSPs allows borrowers with liquidity constraints to shift the closing costs of the loan into their interest payments.[94] However, a recent article in the *Stanford Journal of Law, Business & Finance* concluded that it is

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87. *Id.* at 8.

88. RESPONSIBLE LENDING, *supra* note 78, at 2.

89. *See* ERNST, STEERED WRONG, *supra* note 85, at 5.

90. RESPONSIBLE LENDING, *supra* note 78, at 2.

91. *See* KEITH S. ERNST, BORROWERS GAIN NO INTEREST RATE BENEFITS FROM PREPAYMENT PENALTIES ON SUBPRIME MORTGAGES 1 (2005).

92. ACORN.org, Predatory Lending Practices, http://acorn.org/index.php?id=754 (last visited Nov. 15, 2008).

93. 25 Cal. Rptr. 3d 500, 508 (Ct. App. 2005).

94. This is called a "no closing cost" loan. In a no-closing-cost loan, the broker inflates the interest rate and uses funds from the YSP to cover the closing fees. *See* ZeroMillion.com, Home Mortgages: Does a No Closing-cost Loan Make Sense for You?, http://www.zeromillion.com/financial-services/home-mortgages-does-a-no-closing-cost-loan-make-sense-for-you-by-douglas-hanna.html (last visited Nov. 15, 2008). The borrower would then make up for the closing fees by paying more interest over the life of the loan. *Id.* While the concept is sound, equity theft occurs if a broker charges a higher-than-necessary interest rate but pockets the excess funds. RESPONSIBLE LENDING, *supra* note 78, at 1.

doubtful brokers use YSPs to aid borrowers with liquidity constraints.[95] Rather, loan originators have used YSPs as a common and substantial source of additional compensation.[96] Research has shown that borrowers receive less than thirty-five cents of value for every dollar paid in YSPs.[97] Altogether, YSPs have been used to increase compensation for brokers at the expense of consumers without substantial justification, and Division 1.6 fails to address this practice.

C. Problem II: Loose Underwriting Standards

California Financial Code section 4973(f)(1) was meant to address the responsibilities of the loan originator in assessing the ability of the borrower to repay the loan obligation.[98] In order to avoid liability, a loan originator must "reasonably believe" that the consumer will be able to repay the loan.[99] In the first clause of the second paragraph, the statute adds:

> The consumer shall be presumed to be able to make the scheduled payments to repay the obligation if, at the time the loan is consummated, the consumer's total monthly debts, including amounts owed under the loan, do not exceed 55 percent of the consumer's monthly gross income.[100]

Under this rule, a loan originator conclusively meets the "reasonable belief" requirement if the borrower's debt-to-income ratio is less than 55 percent.[101]

The presumption that a borrower can repay her loan if her debt-to-income ratio is less than 55 percent is economically irrational. First, section 4973(f)(1) uses *gross* income to calculate the debt-to-

95. Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J.L. BUS. & FIN. 289 (2007).

96. *Id.* at 353.

97. *Id.* at 295.

98. CAL. FIN. CODE § 4973(f)(1) (Deering 2007).

99. *Id.*

100. *Id.*

101. The debt-to-income ratio calculated according to section 4973 is known as the back end ratio. *See* Homes & Communities: U.S. Department of Housing & Urban Development, Glossary, http://www.hud.gov/offices/hsg/sfh/buying/glossary.cfm (last visited Nov. 15, 2008). This involves summing up all of the borrower's monthly debts, including non-housing debt, and dividing it by gross monthly income. *Id.* This is different from the front end debt-to-income ratio, which divides only the mortgage payment by the gross monthly income. *Id.*

income ratio. To understand why this can be problematic, imagine the following scenario: Subprime borrower Jane, who is the head of her household and makes $3,000 per month, holds $1,500 of monthly debt, including the cost of the subprime loan. In this case, her debt-to-income ratio is 50 percent ($1,500 ÷ $3,000 = 0.5). Under section 4973(f)(1), the loan originator can legally presume that Jane will be able to make her loan payments.

But, the $3,000 per month that Jane makes does not include tax deductions. Under 2007 California and federal tax rates, Jane still owes the government an additional $513.03 per month in income tax.[102] Thus, after paying off her debts and taxes, Jane is actually left with only about one-third of her income for the living expenses of her household.[103] Considering that in the 2005 U.S. Bureau of Labor Statistics consumer expenditure survey, the average American consumer spent about 24 percent of his pre-tax income on food and transportation alone,[104] Jane will have a very difficult time paying all of her monthly bills.

The second problem with the 55 percent debt-to-income ratio threshold is that it does not reflect proven industry practices. The Federal Housing Administration, which was established in 1934, offers government-backed housing loans to help reduce the costs of mortgages.[105] In order to prevent homebuyers from agreeing to loans that they cannot afford, the agency sets a debt-to-income ratio threshold to qualify borrowers.[106] According to the 2007 Federal Housing Agency guidelines, the maximum debt-to-income ratio under which a borrower can qualify for a loan is 41 percent.[107] Because the agency already allows a higher ratio threshold than the threshold on most traditional loans,[108] it makes little sense for California to set the ratio threshold at 55 percent. California's

102. *See infra* Appendix A for tax calculations.

103. ($3,000 of income) – ($1,500 of debt) – ($513.03 of taxes) = $986.97, approximately 1/3 of $3000.

104. *See* U.S. BUREAU OF LABOR STATISTICS, CONSUMER EXPENDITURES IN 2005, at 3 (2007), *available at* http://www.bls.gov/cex/csxann05.pdf.

105. *See* Lee Ann Obringer, *How Mortgages Work*, HOW STUFF WORKS, Oct. 8, 2002, http://money.howstuffworks.com/mortgage4.htm.

106. *See* FHA.com, FHA Loan Debt to Income Ratios: Facts and Guidelines, http://www.fha.com/debt_to_income_ratios.cfm (last visited Oct. 31, 2008) [hereinafter FHA Loan Debt to Income Ratios].

107. *Id.*

108. Obringer, *supra* note 105.

threshold permits a loan originator to legally presume that a loan is affordable, even where the debt-to-income ratio is fourteen percentage points higher than the already-high Federal Housing Agency threshold.[109]

Moreover, the Federal Housing Administration's ratio guidelines are applicable to all levels of loans, including prime loans. Because subprime loans carry more risks than prime loans, subprime borrowers should be qualified using a lower debt-to-income ratio than prime borrowers. A recent study analyzing about half of all subprime mortgages in the United States found that the average debt-to-income ratio of subprime loans originated between 2001 and 2006 hovered between 38 to 41.1 percent.[110] Since an alarming percentage of these loans have gone or will go into default,[111] even a 40 percent debt-to-income ratio represents significant risk. By continuing to use an outlandish 55 percent debt-to-income ratio threshold, the California legislature has ignored the warning signs from the subprime mortgage market.

A third problem with using the debt-to-income ratio to determine a borrower's ability to repay is that this ratio does not take into account variations in annual income. For example, under California Financial Code section 4973(f)(1), the debt-to-income ratio may be calculated using "the credit application, the consumer's financial statement, a credit report, financial information provided to the person originating the loan . . . or *any other reasonable means*."[112] Thus, there is no requirement that the broker consider the earnings history of the borrower.

For borrowers whose income fluctuates based on factors such as overtime, bonuses, or seasonal earnings, a debt-to-income ratio calculated using only recent income might not accurately reflect the borrower's long-term ability to repay a loan. Altogether, California has made it too easy for loan originators to meet the "reasonable belief" requirement under section 4973(f)(1). By taking advantage of the presumption in favor of loans that feature a debt-to-income ratio at or below 55 percent, an unscrupulous broker may, without fear of legal consequence, offer a loan to a borrower with the

109. *Id.*; FHA Loan Debt to Income Ratios, *supra* note 106.

110. Demyanyk & Hemert, *supra* note 10, at 6–7.

111. *See supra* notes 36–45 and accompanying text regarding anticipated foreclosures.

112. CAL. FIN. CODE § 4973(f)(1) (Deering 2007) (emphasis added).

expectation that the borrower will default. Upon default, the lending institution would recover the property.[113] The federal government has identified this type of asset-based lending, where a loan is made based on the equity of a property rather than on the borrower's ability to repay, as a predatory practice in the subprime mortgage market.[114] Yet by providing the 55 percent presumption,[115] Division 1.6 permits this predatory practice.

D. Problem III: Negative Amortization

Negative amortization occurs when a consumer's required minimum payment on a loan is less than the full amount of interest and fees due each month.[116] As a result, when the consumer makes only the minimum payment, the underlying principal owed increases.[117]

Negative amortization is dangerous to borrowers for two reasons. First, negative amortization prevents the borrower from building home equity.[118] As the principal grows during the negative amortization period, the amount of interest due also increases.[119] Therefore, the borrower can become trapped in a cycle of making payments primarily or entirely towards interest, while not reducing the principal owed. Like the use of YSPs,[120] the use of negative amortization increases the overall price of the loan.[121]

The second danger of negative amortization is that it increases the likelihood of payment shock.[122] Payment shock occurs when a borrower faces a significant and sudden increase in his monthly

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113. *See* Obringer, *supra* note 105 ("[T]he mortgagee holds a lien on your property and can foreclose said lien and sell your property in the event you default on your mortgage.").

114. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., EXPANDED GUIDANCE FOR SUBPRIME LENDING PROGRAMS 10 (2001), *available at* http://www.occ.treas.gov/ftp/release/2006-107a(Guidance).pdf.

115. *See supra* note 98 and accompanying text.

116. *See* Dugan, *supra* note 76, at 1.

117. *Id.* at 7.

118. *See id.* (it is difficult to build equity because "if the borrower makes another minimum payment [which] does not cover the increased amount of interest, the unpaid deficit—which has also increased—is again added to the loan balance") (alteration in original).

119. *Id.*

120. *See supra* Part III.B.

121. *See* Dugan, *supra* note 76, at 7.

122. *See id.* at 10.

housing debt.[123] Research has indicated that a small increase in the size of payment shock creates a drastic increase to the probability of default.[124] The seductive prospect of low minimum payments is especially attractive to subprime borrowers, who cannot afford higher monthly payments.[125] But because any unpaid interest accrues over time, monthly payments must necessarily increase at some future date.[126] When this occurs, the borrower is likely to suffer payment shock, and if she is unable to meet the new payment minimums, she can lose her home to foreclosure.[127]

California Financial Code section 4973(c) attempts to restrict the use of negative amortization.[128] In particular, a covered loan cannot contain a provision for negative amortization "such that the payment schedule for monthly payments causes the principal balance to increase."[129] Based on this restriction, it appears that the legislature was aware of the dangers of negative amortization. Yet the protection against negative amortization is incomplete because the next provision in section 4973(c) creates an exception allowing the lender to apply negative amortization to first mortgages.[130] This exception encourages unscrupulous brokers to market loans with negative amortization to new homebuyers as affordable products. Subprime borrowers, who characteristically fail to realize the economic consequences of their behavior, are likely to be enticed by the temporary benefits of these loans.[131]

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123. *Id.*

124. *See* Anthony Pennington-Cross, *The Value of Foreclosed Property*, 28 J. REAL EST. RES. 193, 208 (2006) (noting that "once in negative equity, there is little incentive to maintain the property" or "behave responsibly with respect to other obligations," such as making monthly payments).

125. *See* Dugan, *supra* note 76, at 10.

126. *Id.*

127. *See e.g.*, Pennington-Cross, *supra* note 124, at 197–98 ("While other events, typically referred to as trigger events (such as employment and family structure shocks), can lead to missed payments it makes sense for borrowers to default, instead of prepaying the loan . . . .").

128. CAL. FIN. CODE § 4973(c) (Deering 2007).

129. *Id.*

130. Cal. Fin. Code section 4973(c) prohibits negative amortization "unless the covered loan is a first mortgage and the person who originates the loan discloses to the consumer that the loan contains a negative amortization provision." *Id.*

131. *See generally* SENDHIL MULLAINATHAN, PSYCHOLOGY AND DEVELOPMENT ECONOMICS (2004) (applying existing research on economic decision-making psychology to development economics).

Why did the California legislature provide this exception? The reason is that federal law preempts California from regulating negative amortization on first mortgages. Congress enacted the Alternative Mortgage Transaction Parity Act (AMPTA)[132] in 1982 to extend federal mortgage regulations to state housing creditors. AMTPA prohibits states from regulating "alternative mortgage transactions" ("AMTs").[133] The Fifth Circuit has stated that AMTs include "all manner of mortgage instruments that do not conform to the traditional fully-amortized, fixed-interest-rate mortgage loan."[134] As such, subprime mortgages are covered under the definition of AMTs. Specifically, the First Circuit has noted that examples of AMTs include mortgages that "may permit negative amortization."[135] Under these definitions of AMTs, California cannot regulate the practice of negative amortization in a first subprime mortgage.

However, the mortgage industry has changed dramatically since Congress first enacted the AMTPA. In the early 1980s, the country suffered through a severe recession, and high interest rates prevailed.[136] In that environment, Congress recognized that AMTs were essential to ensure an adequate supply of credit secured by residential property.[137] It also recognized that federally chartered depository institutions had been authorized to engage in AMTs, while state creditors had not.[138] In order to prevent the discriminatory impact of federal regulations on state housing creditors, Congress passed AMTPA to give state creditors the power to bypass state regulations on AMTs.[139]

Today, the value of AMTPA is questionable. Until recently, low interest rates and a booming national subprime mortgage market produced an abundance of available credit secured by residential property. There is, however, an indisputable need for better

132. 12 U.S.C. §§ 3801–3806 (2006).

133. *Id.* § 3803(c).

134. First Gibraltar Bank v. Morales, 19 F.3d 1032, 1037 (5th Cir. 1994).

135. Grunbeck v. Dime Sav. Bank of N.Y., 74 F.3d 331, 342 (1st Cir. 1996).

136. Steven Rattner, *Federal Reserve Sees Little Growth in '81 with Continued High Rates*, N.Y. TIMES, Jan. 5, 1981, at A1.

137. *See* 12 U.S.C. § 3801(a)(2) (2006).

138. *Id.* § 3801(a)(3).

139. *Id.* § 3801(b).

regulation of AMTs. Congress should modify the AMTPA and return regulatory power to the states.

In an attempt to reduce the impact of negative amortization, California Financial Code section §4973(c) requires any person who originates a loan with a negative amortization provision to disclose to the consumer that the provision may add principal to the balance of the loan.[140] This provision is supposed to mitigate the risk of payment shock. However, scholars have continued to question the effectiveness of increased disclosure in helping borrowers.[141] Specifically, more disclosure can cause information overload, discouraging the borrower from attempting to understand the details of the loan.[142] Moreover, even if the borrower desires to understand the terms, subprime loans are most prevalent in low-income neighborhoods, where borrowers are less likely than their higher-income counterparts to have any financial education.[143] Overall, it cannot be said that disclosure alone offers sufficient protection for borrowers against the risks of negative amortization. Unfortunately, unless Congress amends or removes AMTPA, California is powerless to regulate negative amortization.

E. Summary of Problems in Division 1.6

In sum, Division 1.6 contains three critical problems that prevent it from being an effective deterrent to predatory lending in the California subprime mortgage market. Division 1.6 fails to regulate yield spread premiums, provides loose underwriting standards, and allows negative amortization on first mortgages. As the next section discusses, recent California legislation should also prove ineffective to cure these problems.

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140. CAL. FIN. CODE § 4973(c) (Deering 2007).

141. *See generally* Lauren E. Willis, *Decision Making and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707 (2006) (discussing the problem of predatory home lending and describing how disclosure can be used in legal regulation of home lending).

142. *Id.* at 767.

143. Steven G. Anderson, Min Zhan & Jeff Scott, *Targeting Financial Management Training at Low-Income Audiences: Bits, Briefs, and Applications*, 38 J. CONSUMER AFF. 167 (2004).

IV. WHY 2007 CALIFORNIA SENATE BILL 385 WILL FAIL TO PREVENT PREDATORY LENDING PRACTICES

A. Overview of Senate Bill 385

California Senate Bill 385, chaptered on October 5, 2007,[144] represents California's latest effort in addressing the problem of predatory lending in the California subprime mortgage market. Similar to Division 1.6, this bill regulates state-chartered financial institutions and state-licensed lenders and brokers.[145] Essentially, the bill requires the commissioners of the Departments of Real Estate, Corporations, and Financial Institutions to apply two federal guidance documents to regulate state-based lending entities. Namely, they will apply the Interagency Guidance on Non-traditional Mortgage Product Risks[146] ("2006 Interagency Guidance") and a Statement on Subprime Mortgage Lending [147] ("2007 Subprime Statement"). Both documents were drafted by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration. Any analysis of Senate Bill 385 necessitates an examination of these two federal documents. The following two sections will identify issues with applying these federal documents in California.

B. Issues in Applying the 2006 Interagency Guidance

The 2006 Interagency Guidance provides suggestions on a variety of home mortgage issues, including loan terms and underwriting standards, portfolio and risk management, and consumer protection.[148] Unfortunately, on the whole, the guidance

144. A bill is "chaptered" by the Secretary of State after it has passed through both houses of the legislature and has been signed by the Governor or becomes law without the Governor's signature. *See* Ken Hurdle, California Senate Office of Research, The California Legislative Process (May 1996), http://www.csun.edu/codtraining/atacp/supplements/fph1.html#link3.

145. CAL. FIN. CODE § 4970(g) (Deering 2007).

146. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

147. Proposed Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10,533 (Mar. 8, 2007).

148. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,613–17.

document lacks the level of specificity needed to create practical benefits.

In its recommended practices,[149] the 2006 Interagency Guidance places a strong emphasis on increasing communication with customers and on providing full disclosure through promotional materials and product descriptions. Yet it is questionable whether these measures actually benefit subprime borrowers. As research has suggested, mandated disclosure does not necessarily allow a customer to make better decisions.[150] To the contrary, research suggests that predatory lenders tend to use the disclosure requirements to their advantage by bombarding the customer with information, in hopes that the borrower will not have the time or willpower to read all of the documents.[151]

The 2006 Interagency Guidance provides a vague instruction regarding disclosure, stating that institutions "should provide consumers with information that is designed to help them make informed decisions."[152] Instead of specifying what information is or is not relevant, the 2006 Interagency Guidance leaves discretion in the hands of loan originators.[153] Without specific regulations, unethical loan originators can simply overload the customer with unnecessary information. Doing so provides the loan process with a "veneer of legality and authority"[154] and also gives the loan originator a defense if litigation arises.

Subsequent to its disclosure recommendations, the 2006 Interagency Guidance provides suggestions regarding the issues of payment shock, negative amortization, and prepayment penalties.[155] Unfortunately, much like the recommended practices on disclosure, these recommendations focus only on apprising the customers of risks, rather than reducing such risks. There are neither numerical guidelines nor suggestions that loan originators should prevent negative amortization or prepayment penalties. Because California

149. *Id.* at 58,617–18.

150. *See* Willis, *supra* note 141, at 831.

151. *Id.* at 790–91.

152. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,617.

153. *Id.*

154. Willis, *supra* note 141, at 794.

155. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,617.

Financial Code section 4973 already regulates the use of negative amortization[156] and prepayment penalties,[157] the 2006 Interagency Guidance does nothing to improve the current situation.

Another problem with the 2006 Interagency Guidance is its failure to restrict the use of "reduced documentation" loans in the subprime market. A reduced-documentation loan substitutes detailed analysis of a borrower's repayment capacity with "assumptions and unverified information."[158] The dangers of this practice are well known, as the 2006 Interagency Guidance notes: "A number of commentators, however, including community and consumer organizations, financial institutions, and industry associations, suggested that reduced-documentation loans should not be offered to subprime borrowers."[159] Despite this observation, however, federal regulators "declined to provide guidance recommending reduced-documentation loans be limited to any particular set of circumstances."[160] Instead, the 2006 Interagency Guidance only "suggests strong quality control and risk mitigation factors with respect to these practices."[161] Again, there is a disturbing trend of placing discretion in the hands of loan originators.

The 2006 Interagency Guidance's failure to regulate reduced-documentation loans in the subprime market is particularly baffling considering the suggestions it provides regarding risk mitigation. The document suggests that the risk-mitigating factors of borrowers include higher credit scores, lower loan-to-value ratios,[162] lower debt-to-income ratios, and significant liquid assets.[163] But none of these factors are likely to be present in a typical subprime borrower.[164] Essentially, the 2006 Interagency Guidance sets forth the following contradictory position: it will permit subprime borrowers to obtain

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156. CAL. FIN. CODE § 4973(c) (Deering 2007).

157. *Id.* § 4973(a).

158. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,614.

159. *Id.* at 58,611.

160. *Id.*

161. *Id.*

162. The loan-to-value ratio is the ratio of money borrowed compared to the property's fair-market value. U.S. Department of Housing & Urban Development, *supra* note 101.

163. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. at 58,614.

164. *See supra* Part II.B.

high-risk, reduced-documentation loans, even though (1) such loans should be issued only when there are proven mitigating factors and (2) subprime borrowers typically do not demonstrate these factors.

Overall, the 2006 Interagency Guidance emphasizes disclosure but fails to place any substantial procedural limits on the activities of loan originators. Although well-designed disclosures could potentially help borrowers make better decisions, giving loan originators full discretion regarding what information to disclose leads only to more, not better, disclosure. Additional disclosure can create information overload, a facade of legality, and a shield for lenders during litigation. Moreover, the 2006 Interagency Guidance does not adequately address areas of particular concern in the subprime market, such as payment shock, prepayment penalties, negative amortization, and reduced-documentation loans. Thus, applying the 2006 Interagency Guidance in California will do little to reduce predatory lending practices.

C. Issues in Applying the 2007 Subprime Statement

The 2007 Subprime Statement suffers from many of the same flaws as the 2006 Interagency Guidance. Notably, the statement contains no discussion regarding negative amortization. In addition, the same issues of vagueness that plague the 2006 Interagency Guidance hamper the potential effectiveness of the 2007 Subprime Statement.

Much like the 2006 Interagency Guidance, the 2007 Subprime Statement grants loan originators significant discretion in the use of reduced-documentation loans,[165] although the 2007 Subprime Statement proposes a stricter standard for the use of such loans.[166] Unlike the 2006 Interagency Guidance, which suggests only that lenders consider mitigating factors, the 2007 Subprime Statement requires that reduced-documentation loans for subprime borrowers "should be accepted *only if there are mitigating factors* that clearly minimize the need for direct verification of repayment capacity."[167] The 2007 Subprime Statement explains that mitigating factors typically arise when a borrower with strong payment performance

165. *See* Proposed Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10,533–36 (Mar. 8, 2007).

166. *Id.* at 10,535.

167. *Id.* (emphasis added).

seeks to refinance an existing mortgage with a new loan of similar size and terms.[168] While these guidelines provide more stringent regulation over reduced-documentation loans, they nonetheless contain two critical problems.

First, not all borrowers are given the option to document their income. In a reduced-documentation loan, lenders charge higher interest rates to offset the increased risk of incomplete borrower information. However, when this risk can be mitigated using discoverable documentation, a loan originator should not be allowed to generate higher interest income by avoiding the documentation process. The 2007 Subprime Statement ignores this scenario because it does not prohibit reduced-documentation loans even when documentation is available.

Second, although the 2007 Subprime Statement requires mitigation factors to exist before a reduced-documentation loan can be issued, there are no numerical guidelines on these factors. The only procedural requirement for the loan originator is to document her reliance on mitigating factors.[169] Because of the discretion given to loan originators, reduced-documentation loans may be justified using inappropriate mitigation factors.

A second significant problem with the 2007 Subprime Statement is its failure to put significant restrictions on underwriting practices.[170] In particular, the statement does not require lenders to escrow for taxes and insurance. An escrow account adds the annual costs of taxes and insurance to the borrower's monthly mortgage payment. Adding these costs to monthly payments is beneficial to borrowers for several reasons. First, it serves as a valuable budgeting device, ensuring that taxes and insurance will be paid on time.[171] Missed taxes or insurance could be highly damaging to a homeowner's financial position.[172] Second, escrow accounts ensure

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168. *Id.*

169. *Id.*

170. Underwriting is the process that a broker or lender goes through to determine the risk involved in assuming a loan. FirstFidelityOnline.com, Mortgage Glossary, http://www.first fidelityonline.com/pub/Mortgage-Glossary.

171. Edwin S. Mills, *The Functioning and Regulation of Escrow Accounts*, 5 HOUSING POL'Y DEBATE 203, 209 (1994).

172. Kentucky Homeownership Protection Center, Frequently Asked Questions, http://www.kyhousing.org/protect (follow "FAQ's" hyperlink).

that homeowners' payments will not vary frequently.[173] If a lender escrows for taxes and insurance, the borrower will have a far better sense of the actual monthly costs of home ownership.[174] When tax or insurance costs increase, the borrower can spread the higher payment to the escrow account over the course of twelve months, avoiding the need to quickly accumulate additional funds.[175] Simply put, escrow accounts provide borrowers with a better estimate of the true monthly cost of homeownership. As such, borrowers with escrow accounts are less likely to overextend their credit in the pursuit of a home.

One argument against escrow accounts is that they hold the borrower's funds over the course of the year, when the funds could be generating interest through investments.[176] However, for low-income, financially illiterate borrowers, it is at least debatable whether the funds outside an escrow would ever be used to generate investment income. Moreover, even in prime mortgage markets, mandatory escrow accounts are routine.[177] Thus, it makes sense to enforce escrow accounts in the subprime market, where the need for a safety net is greater.

The 2007 Subprime Statement requires institutions to consider the cost of taxes and insurance in calculating the borrower's debt-to-income ratio.[178] Since the lender uses the debt-to-income ratio to determine the borrower's repayment capacity, in theory there is sufficient protection against default; therefore, escrow accounts are not necessary. In practice, however, the debt-to-income ratio consideration is insufficient to prevent defaults. First, the ratio is an underwriting device used only by the lender.[179] The ratio is not typically explained to the borrower, so the borrower is not likely to use it to gauge whether she will be able to manage the monthly

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173. Mills, *supra* note 171, at 209.

174. *Id.*

175. *Id.* at 210.

176. Dian Hymer, *What Are the Pros and Cons of Having an Impound Account?*, Feb. 2, 1997, http://www.doityourself.com/stry/impoundaccount.

177. Kenneth R. Harney, *Lack of Escrow Accounts Hurts Subprime Borrowers*, WASH. POST, Mar. 31, 2007, at F1.

178. Press Release, Dept. of the Treasury, et al., Statement on Subprime Mortgage Lending (June 29, 2007) (on file with author).

179. *See* Obringer, *supra* note 105.

payments.[180] Second, and more importantly, the 2007 Subprime Statement does not provide numerical guidance on suitable debt-to-income ratios. It is contradictory for the 2007 Subprime Statement to require specific data, such as tax and insurance costs, to be included in the calculation of a ratio but then make no suggestions regarding a range of reasonable ratio values. In essence, the 2007 Subprime Statement suggests that the loan originator is the only party empowered to decide the affordability of the loan, and the government will not attempt to critique the loan originator's judgment. This notion is distressing, as placing discretion solely in the hands of loan originators has allowed predatory lending to flourish in California.[181]

A third problem with the 2007 Subprime Statement is that it fails to emphasize the disclosure of worst-case-scenario information. As mentioned earlier, information overload is a major reason why additional disclosure fails to aid in the borrower's decision-making process.[182] Here, the statement suggests that consumers should be informed of payment shock, prepayment penalties, balloon payments, costs for reduced-documentation loans, and responsibility for taxes and insurance.[183] But while such information is pertinent, the average borrower is unlikely to understand it or realize its consequences. Scholarly research on decision-making suggests that people reduce most decisions to a small number of salient characteristics.[184] Therefore, it is logical to limit disclosures, perhaps including only the simple but critical information that the typical borrower may understand. One example of this information is a table illustrating the monthly payments required in the worst-case scenario. Presumably, a borrower who accepts a loan knowing the worst-case situation will more likely be able to afford the loan. Although worst-case-scenario information may discourage some borrowers from taking on subprime loans, the subprime crisis in California has reached the point where consumer protection must

180. *See id.*

181. *Bernanke Urges Safeguards for Housing Finance*, L.A. TIMES, Nov. 1, 2008, at C3.

182. Willis, *supra* note 141, at 767.

183. Proposed Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10533-01, 10536 (Mar. 8, 2007).

184. Willis, *supra* note 141, at 767.

take priority over market growth.[185] The 2007 Subprime Statement fails in this regard.

D. Federalism Issue in Applying Senate Bill 385

In addition to the flaws of the recommendations in the two federal documents, there is an overarching concern with applying federal guidance at the state level. As previously discussed, California is economically and demographically susceptible to abusive lending in the subprime mortgage market.[186] Therefore, federal guidelines based on national research may not necessarily provide a solution that resolves the California crisis. As Justice Brandeis famously noted, it "is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory" and "try novel social and economic experiments without risk to the rest of the country."[187] Unfortunately, when California adopts the guidance of national entities, it limits the possibilities for the type of state experimentation Brandeis encouraged.[188] Considering the sluggish response of federal administrators to the subprime crisis,[189] the exceptionally high foreclosure rates in California,[190] and the success of state legislative reform in states with strong predatory lending laws,[191] increasing state regulation in California is desirable. By adopting federal guidelines, however, California Senate Bill 385 leaves the solution of the state predatory lending problem in the hands of federal entities.

V. PROPOSED LEGISLATIVE SOLUTION TO PREVENT PREDATORY LENDING

In order to address the subprime lending crisis in California, I propose a six-part legislative solution. Although the solution does

185. *See supra* Part II.D.

186. *See supra* Part I.E.

187. New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

188. For more discussion on federal preemption in this area, see Baher Azmy, *Squaring the Predatory Lending Circle*, 57 FLA. L. REV. 295 (2005).

189. Press Release, Congresswoman Carolyn Maloney, Congressional Leaders Take Action to Address Subprime Mortgage Crisis (Oct. 4, 2007), *available at* http://maloney.house.gov/index.php?option=com_content&task=view&id=1469&Itemid=61.

190. SCHLOEMER ET AL., *supra* note 13, at 17.

191. WEI LI & KEITH S. ERNST, THE BEST VALUE IN THE SUBPRIME MARKET: STATE PREDATORY LENDING REFORMS 11 (2006).

not address all facets of predatory lending in the subprime mortgage market, it is designed to act as a strong deterrent against the most prevalent predatory practices. The six parts of the solution follow.

A. Modify the "Reasonable Relief" Rule in California Financial Code Section 4973

Currently, section 4973 allows loan originators to legally presume that a borrower can repay a loan if the borrower's debt-to-income ratio does not exceed 55 percent. As discussed above,[192] this presumption is economically irrational and provides corrupt loan originators with an unjustified legal defense. To ensure that borrowers receive reasonable loans, California should make three changes to the presumption.

First, the debt-to-income ratio should be calculated using net income, as opposed to gross income. A ratio calculated using gross income does not accurately reflect the debt burden on the borrower, because gross income does not account for unpaid taxes.[193] The use of net income eliminates this problem.

Second, the ratio figure at which a borrower can presumptively afford a loan should be reduced from 55 percent. Since there is no "magic ratio" that assures affordability, the ratio should be determined using industry experience. Two options exist here. The first option is to align the debt-to-income ratio in section 4973 with the Federal Housing Agency threshold ratio for approving loans. This option is feasible because, as the adoption of California Senate Bill 385 suggests, the state is interested in aligning state standards with national standards. Following the lead of the experienced Federal Housing Agency increases the likelihood that the ratio chosen will be reasonable. Currently, this ratio is 41 percent.[194] The second option for California is to set the threshold ratio at a figure below the average ratio of subprime loans from recent years. Since the subprime crisis has emerged primarily in the last half-decade and the average debt-to-income ratio of subprime loans from 2001 to 2006 was between 38 percent and 40 percent, California should use a ratio below these values. This standard would not mean that

192. *See supra* Part III.C.

193. Obringer, *supra* note 105.

194. *See* FHA Loan Debt to Income Ratios, *supra* note 106.

borrowers with a ratio greater than 38–40 percent could not qualify for a loan; it simply means that such borrowers should not be automatically presumed to be able to repay the loan. This safeguard is a rational response to the high number of loan defaults in recent years.

Third, in calculating the debt-to-income ratio, the loan originator should be required to calculate the average ratio over several past years. Calculating the ratio using only recent income masks fluctuations in income, which can arise from factors such as seasonal work or an inconsistent employment history. Home ownership, particularly when accomplished through a risky subprime loan, should not occur without proving the borrower's economic stability.

Altogether, the three changes above would reduce the loan originator's discretion in underwriting loans. This shift would be an important step towards limiting the number of unjust loans in California.

B. Restrict the Use of Yield Spread Premiums

YSPs are not inherently predatory. In fact, a YSP can be a useful method for shifting the closing costs of the loan into the monthly payments of the loan, thereby reducing up-front costs. This shift can be important for borrowers who have steady income but who do not have substantial liquid savings. Unfortunately, as stated earlier in this Note,[195] YSPs are not typically used to benefit borrowers. Instead, consumers receive less than thirty-five cents per dollar paid in YSPs.[196]

To counteract this trend, California should restrict YSPs to their useful purpose. To achieve this goal, California can require each loan originator to inform the borrower of the lowest possible interest rate on a loan before offering the borrower the option to shift their closing costs into monthly payments using a YSP. With this restriction in place, borrowers can decide for themselves whether they would benefit from a YSP. The restriction would ensure that YSPs are used to benefit borrowers, not to increase loan originator compensation.

195. *See* Jackson & Burlingame, *supra* note 95, at 353.

196. *Id.* at 295.

C. Regulate the Use of Low or No-Documentation Loans

California Senate Bill 385 requires various state commissioners to apply the 2006 Interagency Guidance and the 2007 Subprime Statement to regulate state-based lending entities.[197] As analyzed above, these federal documents fail to adequately restrict the use of "reduced documentation" loans.[198] California should impose additional prohibitions on these types of loans.

The first step is to ensure that borrowers are always given the option to document their income. Where possible, California should require brokers to make a reasonable effort to acquire documentation from the borrower. This requirement would prevent the broker from charging a higher interest rate when it is unnecessary to do so. Although brokers and lenders are not paid to do the IRS's work, this rule would also make it more difficult for borrowers to illegally hide their income. Second, California should set a threshold debt-to-income ratio, above which low-documentation loans must be prohibited. This threshold figure should be lower than the threshold debt-to-income ratio used in California Financial Code section 4973. In section 4973, the debt-to-income ratio is used to indicate the borrower's ability to repay and applies to all "covered loans," regardless of the level of documentation. When dealing specifically with a no-documentation or low-documentation loan, there is greater risk regarding the legitimacy of the borrower's income. Thus, a lower threshold debt-to-income ratio should be used to account for this risk.

D. Standardize the Disclosure Process

Although the 2006 Interagency Guidance and the 2007 Subprime Statement place an emphasis on improving disclosure, their recommendations on disclosure are vague and difficult to enforce. As discussed above, the federal guidance documents place far too much discretion in the hands of the brokers and lenders regarding disclosure.[199] As such, each borrower may receive different information from different loan originators, leaving borrowers more susceptible to predatory practices.

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197. S.B. 385, S. 2007-2008 Reg. Sess. (Cal. 2007).

198. *See infra* Part IV.B (discussing reduced-documentation loans).

199. *See infra* Part IV.B.

To address this situation, California should adopt a standardized disclosure form, to be used by all loan originators in the state. The benefits of this procedure are twofold. First, a standardized form reduces the loan originator's discretion in selecting terms to disclose to the borrower. This scenario ensures consistency between the information provided by different loan originators, thereby improving each borrower's ability to comparison shop for loans. Second, by using a standardized form, the state can control the volume and type of information presented to borrowers, preventing inadequate disclosure. At the same time, the state can also prevent information overload, as the loan originator will no longer be able to flood the borrower with irrelevant information.

In carrying out this procedure, California must provide its citizens with free access to the standardized disclosure form. For instance, the form should be posted for download on public government websites. By having this form available for public viewing, borrowers interested in obtaining a loan will have the opportunity to understand the form at their leisure. Having the opportunity to review the form without time constraints is important because during loan negotiations, borrowers may be under time pressure and truncate their decision-making process.[200]

E. Require the Use of Escrow Accounts for Borrowers with Low Credit Scores

Legislation addressing predatory lending in the subprime market should aim to prevent payment shock. The most efficient way to prevent payment shock is to help borrowers understand the true costs of home ownership. In addition to principal and interest payments, a homeowner faces substantial annual fees in taxes and insurance.[201] To ensure that borrowers set aside sufficient funds to cover these fees when they are due, the majority of subprime loans should include an escrow account.

California should add an escrow account provision to Division 1.6. This provision should make escrow accounts mandatory for all borrowers who possess a credit score below a state-established threshold. Because a borrower's credit score indicates her level of

200. Willis, *supra* note 141, at 791.

201. Obringer, *supra* note 105.

fiscal responsibility,[202] a low credit score provides strong indication that the borrower needs assistance in budgeting her finances. By requiring escrow accounts for borrowers with low credit scores, the state can mandate such assistance.

Behavioral Economics research provides insight into the difficulties borrowers face in planning for the future.[203] Generally, people exhibit short-run impatience and long-run patience, as they prefer immediate rewards in the present but delayed rewards in the future.[204] As an example, most people would rather receive $20 in a year than $19 in 364 days. Yet, the same people would prefer receiving $19 today than $20 tomorrow.[205] This situation arises because a one-day delay in the far-future seems minor, while the same delay in the near-future appears unbearable.[206] This difference in preferences across time creates a direct conflict between a person's plans for the future and the person's actions when the future arrives.[207] In a borrower's case, the conflict lies between present consumption and saving for tax and insurance payments. Although borrowers with strong fiscal responsibility can manage this conflict, borrowers with low credit scores tend to exhibit insufficient self-control. Fortunately, institutions can help solve self-control problems by committing people to a particular path of behavior.[208] An escrow account would serve this purpose well.

F. Increase Transparency in the Subprime Mortgage Industry

To prevent predatory lending practices, the legislature must place loan originators under greater public scrutiny. Although the subprime crisis has received national media coverage, the structure of the mortgage industry remains unclear to the average individual. Because of the multitude of participants in the mortgage-lending channel, it is critical for transactions to have a reasonable level of

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202. *See id.*

203. *See generally* MULLAINATHAN, *supra* note 131 and accompanying text.

204. *Id.* at 5.

205. *See, e.g.*, George Loewenstein, *Anticipation and the Valuation of Delayed Consumption*, 97 ECON. J. 666 (1987).

206. *See id.* at 679–680.

207. MULLAINATHAN, *supra* note 131, at 9.

208. *Id.*

transparency, such that each participant can be held accountable for its actions.

Under the current licensing scheme in California, most mortgage brokers are licensed through the California Department of Real Estate.[209] However, mortgage companies with corporate licenses may assign any employee to originate loans, without individual licensing or accountability requirements for the employee.[210] Because of the lack of uniform standards for loan originators, borrowers may be exposed to inconsistent information and abusive lending practices.

To ensure that loan originators are aware of and following mortgage-lending laws, California should move towards a uniform licensing system. Understandably, such a system will require substantial time to establish. In the interim, the state should, at a minimum, initiate an electronic registry of loan originators. California should require every loan originator to register his or her profile on this registry. These profiles must be accessible to the public, and they should contain relevant information, such as: the license of the loan originator, if any; the experience of the loan originator; the organization(s) she works under; and pending legal actions against the loan originator, if any.

One organization that has focused on the need for transparency in the mortgage lending industry is the UpFront Mortgage Brokers Association ("UMBA").[211] Established in 2006, brokers in this association, called UMBs, vow to do business in an upfront and fully transparent manner.[212] Specifically, UMBs make advance disclosures to customers regarding their fees and the wholesale prices of loans passed through from lenders.[213] Although the UMBA is a relatively new organization, it provides an admirable model of transparency for California to emulate. When California establishes its registry of loan originators, brokers who have joined the UMBA should list

209. CAL. ASS'N OF MORTGAGE BROKERS, *supra* note 23, at 4.

210. *Id.*

211. UpFront Mortgage Brokers Association, http://www.upfrontmortgagebrokers.org/index.asp (last visited Oct. 28, 2008).

212. Jack Guttentag, *What Is an Upfront Mortgage Broker?*, MORTGAGE PROFESSOR'S WEB SITE, Jan. 21, 2008, http://www.mtgprofessor.com/A-UpfrontMortgageBrokers/what_is_an_upfront_mortgage_broker.htm.

213. *Id.*

such membership on their profile. Moreover, the state should incorporate transparency requirements into the licensing process.

VI. CONCLUSION

Predatory lending has contributed strongly to the Subprime Mortgage Crisis in California. Although California Financial Code Division 1.6 establishes a foundation for preventing predatory lending, the requirements therein are insufficient. The recently chaptered California Senate Bill 385 provides little improvement because it is vague and incomplete.[214] To effectively reduce predatory lending in subprime mortgages, I have proposed a six-part solution. The solution includes new laws regulating underwriting standards, yield spread premiums, standardized disclosure, reduced-documentation loans, escrow accounts, and broker licensing and registration. Together, these laws should deter the most prevalent predatory lending practices in the California subprime mortgage market.

214. *See* S.B. 385, S. 2007-2008 Reg. Sess. (Cal. 2007).

APPENDIX

Hypothetical Tax Calculations

The calculations below apply the 2007 California and federal tax rates to a hypothetical subprime borrower with $36,000 of gross annual income.

CALIFORNIA TAX:

INCOME BRACKET	TAX RATE	TAX
First $6,622	0.01	$ 66.22
Next $9,076	0.02	$ 181.52
Next $9,078	0.04	$ 363.12
Next $9,618	0.06	$ 577.08
Next $1,606	0.08	$ 128.48
	Annual Tax:	$1,316.42
	Monthly Tax:	$ 109.70

FEDERAL TAX FOR THE HEAD OF A HOUSEHOLD:

INCOME BRACKET	TAX RATE	TAX
First $11,200	0.10	$1,120.00
Next $24,800	0.15	$3,720.00
	Annual Tax:	$4,840.00
	Monthly Tax:	$ 403.33

TOTAL MONTHLY TAX $ 513.03