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Subprime in the Primetime: Be Wary of Overly Burdensome Predatory Lending Legislation

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Current Climate

Turn on any TV station or read any newspaper and you will find either news, comments or opinions regarding what many call the "subprime meltdown." Who is at fault, when will it be over and how can it be fixed are questions most often asked. Everyone who has studied the issue, including those in the mortgage industry, legislators and consumer advocates have become concerned with the need for legislation to resolve the issues so greatly affecting the U.S. economy. Legislation as a cure for mortgage issues in not a new theory as both state and federal legislatures have, in the not too distant past, taken proactive and, sometimes, overly aggressive legislative steps in that regard. The practical effect of these early efforts, in many cases, has been highly detrimental to the consumer's ability to obtain mortgage financing. Ultimately, legislation must be enacted which balances the need for effective policing of alternative loan products and potential predatory lending with the necessity of a viable subprime market – a market which enables many Americans to achieve their goal of home ownership. As seen below, such a balancing act is often difficult but, in the very least, effective legislation must contain adequate protections for purchasers, assignees or servicers of subprime loans.

Subprime Lending — Relationship to Predatory Lending
"Subprime lending," as we have all heard repeatedly, refers to alternative mortgage programs which extend higher interest rate loans to borrowers who are less secure financially than many Americans but who wish to own their own home.[1] In contrast, the "prime market" extends mortgages to the vast majority of homeowners and typically offers lower rate loans due to the lower financial risk involved. As a result of the higher risk associated with lending money to potential borrowers with less than stellar financial histories, the loan terms offered in alternative loan products includes higher interest rates and other fees which the lending industry contends is necessary in order to compensate for the increased risk in loaning money to consumers with little or no credit or employment history, blemished credit or past bankruptcies. To be clear, subprime loans should not be confused with "predatory lending." While it is true that the vast majority of predatory lending efforts are directed at consumers who may only qualify for loan products with higher costs (the subprime market), it is not true that all subprime lending is predatory in nature.

The subprime mortgage market exploded during the 1990's due to several factors, including the willingness of borrowers to mortgage homes in order to meet consumer debt obligations, the increase in home values and the increased flow of capital into the subprime market.[2] The increased capital was due in large part to the willingness of institutional investors to purchase subprime mortgages as investments and then sell portions of their portfolio as mortgage backed securities.[3] This practice allowed bond insurance to issue in connection with the sale of the security, thereby achieving a sufficient rating to attract mainstream investors and shifting the risk inherent with such mortgages from investors to insurers.[4] The practice therefore provided originating lenders the ability to realize immediate profits from the sale of subprime loans but, as shown herein, has raised pressing questions regarding the liability of investors for predatory lending tactics.

Legislation: Will History Repeat Itself?

Legislation to protect consumers from unscrupulous and predatory lending products is to be applauded. However, history has indicated that government will often make a knee-jerk reaction to the problem resulting in legislation which brings lending to the underserved to a fast standstill. In the 1990's, in response to the perceived increase in predatory and abusive lending practices, state and local authorities enacted legislation and ordinances aimed at reducing abusive practices. In large part, enactment of local legislation was simply an extension of federal statutes including the Truth in Lending Act (TILA)[5] which requires the disclosure of finance charges and loan payment totals, the Home Ownership and Equity Protection Act (HOEPA)[6] which requires further disclosures and limits loan provisions for certain loans and the Real Estate Settlement Procedures Act (RESPA)[7] which requires the disclosure of certain settlement costs and business arrangements and prohibits payments for business referrals. [8]

Although well-intentioned, state and local legislation often has had the effect of harming the very consumers which it intended to protect. A prime example of such ill-conceived legislation occurred in the State of Georgia in 2002 when, spurred on by consumer groups and supported by then Governor Roy Barnes, the Georgia Legislature enacted a law designed to impose severe penalties on all creditors associated with the originating, assigning, servicing or purchasing of certain loans. The Georgia Fair Lending Act (GFLA), O.C.G.A. §7-6A-1 et seq., was passed on April 22, 2002 and took effect on October 1, 2002. As originally enacted, the GFLA placed certain restrictions and prohibitions on what it defined as "home loans," "covered home loans" and "high cost loans." Importantly, the GFLA originally defined "creditor" to include purchasers, assignees and servicers, meaning such down-stream or secondary mortgage market participants could face liability under the GFLA in the event they came into contact with a predatory loan.

In response to the legislation, many lenders and secondary mortgage market participants began to shy away from Georgia loan products, afraid of the GFLA's "assignee" liability provisions and the potential ramifications to their business if they, even inadvertently, purchased or serviced predatory loans. In addition, Fitch and Standard & Poor (S&P) refused to rate mortgage backed securities which may contain loans subject to the GFLA. On January 24, 2003, S&P stated that its decision to not rate "mortgage-backed securities transactions that contain mortgages that might violate" the GFLA was based on its opinion that "the inclusion of such mortgages would negatively impact the creditworthiness of the rated transactions."[9] In addition, S&P indicated that in light of the assignee liability provisions of the GFLA, it "believes that such transferred liability would negatively impact the investors in any mortgage-backed transaction that held such mortgages."[10] In response to this and other negative reactions by rating agencies, then Georgia Governor Sonny Perdue recognized that if the secondary market for Georgia home loans was eliminated, "fewer home mortgage lending options may be available for Georgia citizens."[11]

In response to the impending crisis, the Georgia Legislature, on March 6, 2003, amended the GFLA and, in so doing, narrowed the scope of potential assignee liability for violations of its provisions. For example, the definition of the term "creditor" was changed to delete reference to assignees and purchasers of home loans.[12] In the amended GFLA, the defined term "creditor" now specifically excludes assignees, servicers, purchasers and "any state or local housing finance agency or any other state or local governmental or quasi-governmental entity."[13] Further, even though the amendment provided for assignee liability, it was limited to situations where the assignee failed to exercise certain reasonable due diligence with regard to the purchase of "high cost loans."[14] Even then, such claims are subject to a one-year statute of limitations and damages flowing from any liability established under the GFLA are capped.[15]

A Balancing Act – Protection of the Consumer While Protecting Against Negative Market Consequences

As the consequences of the original Georgia legislation indicated, legislators must be cautious when crafting laws effecting mortgage loan origination even when designed for well-intentioned reasons such as curbing predatory lending practices. Without an understanding of why there is a continued need for alternative loan products such as subprime loans, albeit coupled with limitations against illegal predatory practices, overly broad legislation will likely result in creating a class of working consumers who can no longer qualify for mortgage loans.

While there is no question that predatory lending must be prevented and punished by statute, the regulation of such wrongful conduct must be balanced against the need to provide alternative loan products for consumers who cannot qualify for lower cost loans. There is no question that there is a need for such alternative products priced in accord with market forces. A balance between overbroad legislation such as the pre-amendment GFLA and legislation armed with sufficient enforcement mechanisms to dissuade lenders from predatory practices is necessary in order to effectively police the industry without eliminating the ability of many Americans to obtain mortgage financing.

To be certain, any predatory lending legislation which imposes significant liability on downstream investors must be scrutinized heavily and, in the very least, limit such liability to cases involving willful noncompliance with specific due diligence requirements or outright fraud. In exchange, legislation should shield from liability those assignees who comply with the due diligence requirements. The practical effect of such an approach would be to decrease the likelihood that originating lenders use predatory lending techniques to originate mortgages as they would lose the ability to sell those mortgages for profit in the secondary market and would, instead, be forced to bear the credit risk alone.

Where Do We Go From Here?

There is no doubt that there will be new federal legislation enacted aimed at policing alternative loan products. However, legislators must be mindful to study the problem carefully including affects on both consumers and the marketplace to guard against overly aggressive policies which may ultimately hinder a consumer's ability to achieve the American dream of home ownership. As Georgia's legislative experiment showed, even laws with good intentions can have damaging effects. Consumers must also become informed and watchful and ask questions when obtaining mortgage debt. Finally, the mortgage industry must take a strong look at itself and make a determination that history will not repeat itself. Only if consumers, legislators and lenders work hand in hand can a sensible, well-intentioned and strong resolution can be achieved.

1. Department of Treasury and Department of Housing and Urban Development, "*Curbing Predatory Home Mortgage Lending: A Joint Report*" (June 2000), p.27.
2. *Id.* at p. 30
3. *Id.* at p. 41-43.
4. *Id.*
5. *See* 15 U.S.C. §1601 et seq.
6. *See* 15 U.S.C. §1639 et seq.
7. 12 U.S.C. §2601 et seq.
8. See Department of Treasury and Department of Housing and Urban Development, "*Curbing Predatory Home Mortgage Lending: A Joint Report*" (June 2000) at p.3.
9. "S&P Comments on Georgia Fair Lending Act Announcement," New York (Business Wire), January 24, 2003.
10. "Fitch Declines to Rate Georgia Loans In RMBS Pools & Considers Impact to Other Predatory Lending Legislation," New York (Business Wire), February 4, 2003.
11. Georgia.gov – 2003 Press Releases, Office of the Governor, State of Georgia, Statement of Governor Sonny Perdue, January 22, 2003.
12. O.C.G.A. §7-6A-2(6).
13. *Id.*
14. O.C.G.A. §7-6A-6.

15. *Id.*