LEGISLATIVE LAW

The Mortgage Crisis Did Not Have to Happen

by Ted W. Lieu
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Ted W. Lieu (D-53) is serving his third term in the California Legislature and chairs the powerful Joint Rules Committee. He is currently the only elected official running for Attorney General from Southern California. He was recently promoted to Lt. Col., U.S. Air Force Reserves. On active duty, he served in the JAG Corps as a military prosecutor. Ted previously served on the Torrance City Council, practiced civil law, and was in-house counsel at a brokerage firm. He graduated with a B.S. in Computer Science and a B.A. in Political Science from Stanford University, and received his Juris Doctor from Georgetown University Law Center. He is married to Betty Chim, a former Deputy Attorney General, and has two rambunctious children, Brennan and Austin.

Gordon Gecko in the movie *Wall Street* said, "Greed is good….Greed is right, greed works." What we have learned, however, is that unchecked and unregulated greed on real-life Wall Street wreaked havoc in the mortgage industry, triggering the worst recession since the Great Depression.

The combination of lax government oversight, coupled with laws that made it next to impossible for distressed homeowners to bring lawsuits against Wall Street banks and mortgage brokers, made California the Wild West of uncontrolled lending practices. If stronger laws had been in place a decade ago that outlawed predatory lending practices and gave consumers a private right of action to enforce those laws, a crisis of this magnitude would never have happened.

Instead, as a result of the foreclosure crisis, families have been torn apart, communities destroyed and a global financial meltdown ensued. I firmly believe we have a responsibility to prevent this kind tragedy from happening again.

While there is plenty of blame to go around, from Wall Street banks to ratings agencies to homeowners with little or no financial literacy, the roots of the foreclosure crisis can be traced to three policy decisions made by former Federal Reserve Chairman Alan Greenspan.

First, by reducing the federal funds rate to 1% in 2003 and refusing to increase it for a year, Greenspan created the conditions for rampant investor speculation and a loosening of loan underwriting standards as lenders frenetically competed for market share.

Second, Greenspan shunned increased regulations. In the aftermath of "The Market Will Regulate Itself" era, Greenspan has now admitted that regulation is a necessary component of a healthy market. He has also admitted knowing about abuses in the subprime loan industry and has now apologized for his inaction.

Third, Greenspan promoted the non-traditional mortgages that brought down some of our largest financial institutions and pushed us into an economic disaster. In a speech on Feb. 23, 2004, Greenspan stated that consumers were paying too much for fixed-rate mortgages and asked lenders to provide "greater mortgage product alternatives to the traditional fixed-rate mortgage."

Wall Street followed Greenspan's advice and designed a whole range of risky, exotic mortgages. Millions and millions of risky loans were sold -- sometimes fraudulently -- on a mass scale to a public ill-informed about their significant risks. For example, the “stated income loan” was originally designed for people with high net worth who did not want to disclose their income. This loan required no income verification. Wall Street, however, started marketing these loans to the general public, including subprime borrowers. Not asking for income verification of a subprime borrower—which is already someone with a riskier credit history—is asking for disaster. That is why Ameriquest and New Century no longer exist.

Some lenders marketed the negative amortization loans to subprime borrowers. This is a loan in which the borrower cannot even pay enough each month to cover the interest payment so that the difference is added to the principal. The longer the borrower holds the loan the larger the loan becomes. Wachovia Bank sold many of these loans, also known as “pick a payment” loans, and many of these borrowers defaulted. That is one reason Wachovia no longer exists.

Some lenders and brokers sold adjustable rate loans without caring if the borrower could pay back the loan. Countrywide sold loans in which the first two or three years would be a low teaser rate of, say, 2% and then it would spike upward for the remaining loan term. Brokers were offered incentives, such as higher commissions, for steering a borrower into a subprime loan even though the borrower had qualified for a prime, fixed rate loan. Two studies, one commissioned by the Federal Reserve, found that up to 55% to 60% of subprime borrowers had actually qualified for a traditional fixed rate prime loan.

I can guarantee the following disclosures never occurred at Countrywide:

“Congratulations Mr. and Mrs. Smith, we have approved you for a 30-year adjustable-rate home loan. We know you also qualified for a lower-interest, fixed rate loan but we are selling you the riskier adjustable loan because we make more commission. We know you can only pay the first two years. We know you can’t pay the remaining 28 years when the loan interest spikes, but we are giving the loan to you anyway.”

Countrywide didn’t care if the homeowner defaulted two or three years later because they would sell the loan upstream to Wall Street firms and pocket the commission.

The greed and arrogance of investment firms such as Bear Stearns, Lehman Brothers and Merrill Lynch caused them to buy these exotic subprime loans in massive quantities, which they then bundled into mortgage-backed securities. Buying one subprime loan is a risky investment. Somehow the best and brightest on Wall Street, including the rating agencies, concluded that buying a lot of the same subprime loans and putting them together would magically reduce the risk. It is the same twisted logic as saying that playing 10,000 hands of blackjack is less risky than playing one hand of blackjack. Mathematically the risk is exactly the same, except the potential losses are multiplied 10,000 times. That is one reason these three venerable firms no longer exist.

As distressed homeowners started defaulting on subprime products because they were unable to make the increased monthly payments and could not refinance due to unconscionable prepayment penalties, California's foreclosure rate began to explode. Wave after wave of foreclosures shocked the financial markets and devastated our economy.

California became ground zero for foreclosures. We average 80,000 foreclosure filings a month in our state. That is approximately one foreclosure filing every 30 seconds. Until we slow this down, our economic recovery will be hampered.

When I took over as Chair of the Assembly Banking and Finance Committee, I stood up to powerful interests on Wall Street. I was determined to try to stem the tide of foreclosures as well as pass new laws to reform the mortgage industry so a crisis of this magnitude can never happen again. Together with consumer groups, including the Consumer Attorneys of California, housing advocates, labor organizations and financial experts, we set out on a mission to reform the mortgage industry.

After multiple hearings in 2007, I introduced AB 1830 in 2008, which was landmark mortgage reform legislation to ban some of the worst practices in the mortgage market. The bill was one of the few bills to get through the legislature that contained a private right of action and attorneys' fees for the prevailing plaintiff. Unfortunately, Wall Street's grip continued to stand in our way. The Governor vetoed the bill.

This year, however, through pressure from consumer groups, consumer attorneys, my office and the millions of voters who are incredibly upset at the mortgage industry, the Governor signed a significant number of mortgage and foreclosure reform bills.

I authored the California Foreclosure Prevention Act of 2009, which became effective in July. This bill, the first of its kind in the nation, requires both state and federally-chartered banks and credit unions to run comprehensive loan modification programs designed to keep people from going into foreclosure. If the bank or lender chooses not to operate a loan modification program, it will incur a 90-day foreclosure moratorium on all of its home loans. We essentially use the state-controlled foreclosure process to compel systematic loan modifications across California.

The Governor also signed my bill AB 260, the Subprime Mortgage Reform Act of 2009. This bill bans some of the worst predatory practices in the subprime industry, such as steering, bans the selling of the negative amortization loan to subprime borrowers, imposes fiduciary duties on brokers and banks acting as brokers and puts caps on prepayment penalties.

Two other important bills the Governor signed include SB 94 by Senator Ron Calderon and AB 1160 by Assemblymember Paul Fong. I am a co-author of both bills. SB 94 bans upfront fees of loan modification companies until the work promised by the company has been completed. AB 1160 requires that the main terms of the home loan be translated in writing if the loan was negotiated in a language other than English.

While these bills are significant, more work needs to be done. I am a joint author of AB 1588 which will be heard in the upcoming session. This bill provides a state mediator to every borrower facing foreclosure. The mediator would work to get the borrower and the lender to come up with a loan modification. If the two parties fail, then the mediator will submit what the mediator believes is a fair loan modification proposal that the consumer can enforce in court. This is the kind of aggressive action that we continue to need to reign in Wall Street, help consumers and restore our economy.