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REGULATE PREDATORY LENDING & PREEMPT LOCAL REGULATION

House Bill 6121 as enrolled
Public Act 660 of 2002
Second Analysis (1-13-03)

Sponsor: Rep. Andrew Richner
House Committee: Commerce
Senate Committee: Banking and Financial Institutions (Discharged)

THE APPARENT PROBLEM:

A recent newsletter from the Michigan Civil Rights Commission featured an article on the dangers posed to homeowners from "predatory lending." The newsletter defined predatory lending as "a practice by which certain lending institutions use high fees and interest rates, outrageous costs, and uncalled for insurance coverage, terribly large payments, repeated financing, and other dishonest lending practices to strip equity from one's home". The article says, "These costs may be applied even though the applicant qualifies for more favorable loans", and adds that, "many homeowners never climb out of this debt and end up losing all their savings in equity as well as their properties". The commission newsletter says that "predatory lenders systematically target first time homeowners, low-income homeowners, and property owners with huge debt loads. Young homeowners, senior citizens, and poorly educated people are often targeted as well". These practices are associated (although not exclusively) with the "subprime" lending market, meaning loans to customers who do not qualify for "prime" loans due to their credit or employment history and are also associated with second mortgages or the refinancing of mortgages. This issue has become more prominent because lending based on home equity has increased dramatically in the past few years. (Housing values are up and interest costs on home equity are deductible for federal income tax purposes.) Further, subprime home equity lending increased more than 500 percent from 1994 to 1998, according to one web site devoted to the subject, ResponsibleLending.org. The number of mortgage brokers originating subprime loans has tripled in the past five years, says that organization. This is not to say that subprime loans are in and of themselves a problem, only that problems are said to be more common in that market.

This fall, the National Association of Attorneys General reached what they called a landmark settlement that they say will set new standards for the lending industry. According to information from the NAAG, "Mortgage lender Household Finance Corp. has agreed with state regulators to change its lending practices – and to pay up to $484 million in consumer restitution nationwide for alleged unfair and deceptive lending practices in the 'subprime' market". The settlement covers loans taken out between January 1, 1999 and September 30, 2002. Michigan participated in the multi-state investigation of lending practices and is a party to the settlement, under which, according to the state's Office of Financial and Insurance Services, about 10,000 Michigan consumers could receive up to $14 million. OFIS, which is in charge of the settlement plan, has said that "Four Household lending practices caused harm to Michigan consumers, mostly in the second mortgage market . . . The first is home equity lines of credit that were allegedly issued as a second loan to pay for fees relating to the first loan. Second, Household appears to have assessed inappropriate prepayment penalties. Third, [the company] issued 'live checks' to consumers that automatically created a loan with a signature. Fourth, Household allegedly included large amounts of credit insurance on real estate loans – sometimes without the consumer's knowledge".

How to regulate these and other lending practices is a contested issue. Some regulators and finance industry representatives say that existing laws at the federal and state law are sufficient to address abuses in the lending industry and that what is needed is vigorous enforcement coupled with increased consumer education. Some consumer advocates believe current regulation is insufficient, and that legislation is needed that specifically targets what they consider to be the common characteristics of predatory lending practices. Nationwide, there have been efforts by community-based groups to pass ordinances at the local level prohibiting or restricting certain lending practices. In Michigan, the Detroit City Council is currently considering such ordinances. Discussions have also taken place in Grand Rapids. Some people, however, believe that the marketplace is better served with uniform regulation at the state or federal level, rather than a checkerboard of different rules from place to place.

THE CONTENT OF THE BILL:

The bill would create the Consumer Mortgage Protection Act, which would:

• Prohibit certain acts in offering to make or making some kinds of mortgage loans (e.g., refinancing loans and home equity loans) and provide for enforcement against violations;

• Require a lender at the time a person applied for a mortgage loan to provide the borrower with a "bill of rights" (described later) and with a written notice (spelled out in the bill) about the value of receiving credit counseling before taking out a mortgage loan and a list of the nearest available HUD-approved credit counseling agencies;

• Specify that the business of brokering, making, servicing, and collecting mortgage loans are to be solely regulated by federal and state governments and prohibit and preempt such regulation by municipal corporations or other political subdivisions of the state; and

• Require that, no later than December 1, 2003, the Office of Financial and Insurance Services develop and make available to local units of government, financial institutions, and other interested persons one or more model programs for financial education. The program would have to be designed to teach personal financial management skills and the basic principles involved with saving, borrowing, investing, and protection against predatory and other fraudulent lending practices.

Definition of "Mortgage Loans". The bill would define the term "mortgage loan" to refer to a loan or home improvement installment contract secured by a first or subordinate mortgage or any other form of lien or land contract covering real property located in the state used as the borrower's principal dwelling and designed for occupancy by four or fewer families. The term would not apply to loans in which the proceeds were used to acquire the dwelling; reverse-mortgages; or open-end credit plans (loans where the lender reasonably contemplated repeated advances).

Prohibited Acts. The bill would require that a person (meaning an individual or entity) broker, make, or service mortgage loans in accordance with all applicable state and federal laws (and the bill contains a list of such laws). Further, the bill would prohibit:

-- a person offering to make or making a loan from 1) charging a fee for a product or service if the product or service was not actually provided to the customer; and 2) misrepresenting the amount charged by or paid to a third party for a product or service.

-- a person, appraiser, or real estate agent from making, directly or indirectly, any false, deceptive, or misleading statement or representation in connection with a mortgage loan, including the borrower's ability to qualify for a mortgage loan or the value of the dwelling that will secure repayment of the loan.

-- a person from directly or indirectly compensating, coercing, or intimidating an appraiser for the purpose of influencing his or her independent judgment with respect to the value of the dwelling offered as security for the repayment of a loan.

-- a lender from conditioning the payment for an appraisal on a predetermined value or on the closing of the loan.

-- a lender in making a mortgage loan from financing as part of the loan single premium coverage for any credit life, credit disability, or credit unemployment.

-- a lender from inserting or changing information on an application for a loan if the lender knew that the information was false and misleading and was intended to deceive a third party that the borrower was qualified for the loan when in fact the third party would not approve the loan in the absence of the insertion or change.

-- a mortgage loan note from containing blanks regarding payments, interest rates, maturity date, or amount borrowed to be filled in after the note was signed by the borrower.

Amortization Requirement. A mortgage loan with a term of less than five years could not have a payment schedule with periodic payments that when aggregated did not fully amortize the outstanding principal balance. This would not apply to loans with maturities of less than one year if the purpose of the loan was a "bridge" loan connected with the acquisition or construction of a dwelling intended to become the borrower's principal dwelling.

Deceptive and Misleading Representations. Under the bill, a statement or representation would be considered deceptive or misleading if it had the capacity to deceive or mislead a borrower or potential borrower. The commissioner of the Office of Financial and Insurance Services would consider the following factors in deciding whether a statement or misrepresentation was deceptive or misleading: 1) the overall impression that it reasonably created; 2) the particular type of audience to which it was directed; and 3) whether it could be reasonably comprehended by the segment of the public to which it was directed.

Commissioner's Role. The commissioner of the Office of Financial and Insurance Services could conduct examinations and investigations of a person over which he or she had regulatory authority in order to determine if the person was brokering, making, servicing, or collecting mortgage loans as required by the new act. If the commissioner determined a violation was occurring, he or she would have to initiate a cause of action with the attorney general or a county prosecutor; enforce the penalties and remedies under the appropriate state law, if the person was chartered, licensed, registered, regulated, or administered under that law by the commissioner; or forward a complaint to the appropriate regulatory or investigatory authority.

A.G. and Prosecutors. The attorney general or a county prosecutor could bring an action to obtain a declaratory judgment that a method, act, or practice was a violation of the act; enjoin a person engaging in or about to engage in such a method, act, or practice; and/or obtain a civil fine of not more than $10,000 for the first offense and not more than $20,000 for a second or subsequent offense.

Excuses and Corrections. A person would not be liable for a violation if the person showed it was an unintentional and bona fide error, including a clerical, calculation, computer malfunction, programming, or printing error. However, an error in legal judgment with respect to a person's obligations would not be a bona fide error. A person would also not be liable for a violation if, within 60 days of the discovery of the violation and before the institution of an action, the person notified the borrower or buyer of the violation and corrected it so as to restore the borrower or buyer to the position he or she would have been in if the violation had not occurred (to the extent it was reasonably possible to do so.) The person alleged to have committed the violation would have the burden of proving he or she is not liable.

Preemption of Local Regulation. The bill would specify that any charter, ordinance, resolution, regulation, rule, or other action by a municipal corporation or other political subdivision of the state to regulate, directly or indirectly, the brokering, making, servicing, or collecting of mortgage loans would constitute a statutory conflict with the uniform operation throughout the state of residential mortgage lending and would be preempted. This would include local actions to disqualify a person, or its subsidiaries or affiliates, from doing business with the municipal corporation or other political subdivision or to impose reporting requirements or other obligations. Further, any charter, ordinance, resolution, regulation, rule, or other action to collect information about, require reporting of, pledges regarding, notices, or certifications concerning loans, lenders, applicants, deposits, or credit experiences, character, and criminal background checks of employees, agents, customers, or other persons would be preempted. The bill would specify that the laws of this state regarding brokering, making, servicing, and collecting of mortgage loans prescribed rules of conduct upon citizens generally, constituted a comprehensive regulatory framework intended to operate uniformly throughout the state under the same circumstances and conditions, and constituted general laws of the state. It would further specify that silence in the statutes regarding mortgage loans was not to be interpreted to mean that the state had not completely occupied the field or had set only minimum standards.

Statement of Intent. The bill would specify that "It is the intent of the legislature to entirely preempt municipal corporations and other political subdivisions from the regulation and licensing of persons engaged in the brokering, making, servicing, or collecting of mortgage loans in the state".

Borrower's "Bill of Rights". The bill would require, as mentioned earlier, that a lender provide a document referred to as the "borrower's bill of rights" to a person at the time he or she applies for a loan. This document would contain the following ten statements:

You have the right to shop for the best loan for you and compare the charges of different mortgage brokers and lenders.

You have the right to be informed about the total cost of your loan, including the interest rate, points, and other fees.

You have the right to obtain a "good faith estimate" of all loan and settlement charges before you agree to the loan or pay any fees.

You have the right to know what fees are nonrefundable if you decide to withdraw your loan application.

You have the right to ask your mortgage broker to explain exactly what the mortgage broker will do for you.

You have the right to know how much the mortgage broker is getting paid by you and the lender for your loan.

You have the right to ask questions about charges and loan terms that you do not understand.

You have the right to a credit decision that is not based on your race, color, religion, national origin, sex, marital status, age, or whether your income is derived from public assistance.

You have the right to know the reason if your loan application is turned down.

You have the right to receive the HUD settlement costs booklet "Buying Your Home".

Consumer Caution and Home Ownership Counseling Notice. The bill also would require that a person applying for a loan be provided a written notice about the value of receiving credit counseling before taking out a mortgage loan and a list of the nearest available HUD-approved credit counseling agencies. The bill prescribes in detail the content of the notice.

BACKGROUND INFORMATION:

As it progressed through the legislature, House Bill 6121 was accompanied by six related bills, each of which would have amended a separate existing act in order to make the entities regulated under those acts also subject to the new act created by House Bill 6121. The related bills, however, were not enacted by the end of the 2001-2002 session. The related bills were House Bill 6122, which would have amended the Mortgage Brokers, Lenders, and Servicers Licensing Act (MCL 445.1674a); House Bill 6123, which would have amended the Credit Union Act (MCL 490.10a); House Bill 6124, which would have amended the Savings Bank Act (MCL 487.3435); House Bill 6125, which would have amended the Banking Code of 1999 (MCL 487.14206); House Bill 6126, which would have amended the Secondary Mortgage Loan Act (MCL 493.74a); and House Bill 6127, which would have amended the Savings and Loan Act of 1980 (MCL 491.737).

FISCAL IMPLICATIONS:

The House Fiscal Agency notes that several provisions in the bill would increase costs to the Office of Financial and Insurance Services, which would be met out of restricted revenues imposed on regulated entities. Costs would increase from authorizing the commissioner of OFIS to conduct examinations and investigations of regulated entities related to new provisions in law; requiring OFIS to enforce the bill's provisions for regulated entities or forward complaints to the appropriate regulatory or investigatory authority; and requiring OFIS to develop and make available to local units of government, financial institutions, and others, one or more model programs for financial education. The HFA points out that the bill also prescribes maximum civil fines for violators of $10,000 for a first offense and $20,000 for subsequent offenses. This could increase state and/or local revenue to the extent that violations occur and are successfully prosecuted. (HFA fiscal analysis dated 1-13-03)

ARGUMENTS:

For:

The bill would in several ways address the issue sometimes described as predatory lending. First, it would strengthen current state regulation by prohibiting deceptive and misleading practices associated with home equity loans and refinancing loans, and prohibiting other abusive practices. Second, it would encourage increased consumer education by requiring state lending regulators to put together and distribute model financial education programs. Third, it would make it clear that the regulation of this kind of mortgage-related lending was a function of the state (and federal) government and that the rules governing residential mortgage lending should be uniform throughout the state and not subject to local regulation. A patchwork of local regulation would create confusion in the credit markets and make it difficult to sell loans in the secondary market. The stated aim of the legislation is to protect consumers without at the same time drying up the credit market for those who need or want to borrow.

Specifically, the legislation would prohibit deceptive and misleading statements or representations about certain kinds of mortgage-related loans, including the ability of the borrower to qualify for the loan or the value of the home securing the repayment. It also would provide guidance to state banking regulators in determining when such statements or representations had been made by basing violations on the audience to which the statement and representations had been made and that audience's likely level of comprehension, as well as on the overall impression created. This provides regulators with clear standards to use in evaluating the behavior of lenders and the flexibility to make judgments about whether the standards had been breached in particular transactions. State regulators, local prosecutors and the state attorney general would be empowered to take action against such practices and new civil fines would be introduced.

Response:

In testimony presented to the House Commerce Committee, the commissioner of OFIS said "Michigan law is already very complete when it comes to providing the regulator with the tools necessary to combat abusive predatory practices", and noted that "Ultimately, combating predatory practices is a matter of investigation and enforcement". Most of the conduct that critics point to is already illegal or can be dealt with under existing statutes. The commissioner and others have cited the recent passage of legislation (Public Acts 390-394 of 2002) that allows the commissioner to bar "bad actors" from future employment in regulated financial professions as a key additional element in the regulatory toolkit.

Against:

Critics of this legislation say it simply does not provide sufficient regulation of predatory lending. It barely advances state oversight beyond the current law, which is inadequate. Moreover, by preempting local regulation, the bill would strip municipalities of the ability to protect their own citizens against abusive practices. While it may make sense in theory to have uniform lending standards statewide, this is only true in practice if those uniform state regulations are sufficient to protect consumers. There are a number of preferable alternatives to this legislation. Other states have stronger predatory lending laws, and there are other proposals for amending Michigan law that would do more to provide protection to vulnerable consumers.

One model act put forth for discussion by a group advocating on behalf of low-income people would ban practices that are intrinsically linked to predatory lending. For example, this proposed model act would ban balloon payments and negative amortization (where the principal can increase during the loan) connected with "high-cost" home loans, and would specifically prohibit loans made without regard to the customer's ability to repay and without homeownership counseling. (High-cost loans would be defined in the model act as loans bearing interest rates and fees exceeding certain thresholds.) The proposed model would also prohibit "flipping", defined as refinancing an existing home loan when the new loan does not have a reasonable, tangible net benefit to the borrower; prohibit prepayment fees; prevent the financing of credit insurance along with the loan, known as "packing"; restrict late payment fees; and prohibit the acceleration of the indebtedness at the sole discretion of the lender. It would also allow private actions (rather than just enforcement by public agencies and officials). Consumer advocates say legislation similar to this has been enacted in North Carolina and elsewhere without a decrease in the availability of loans. Consumer education is important, but abusive lenders are said to apply high pressure tactics and target vulnerable consumers, which means that increased consumer education alone is not a practical approach to solving this problem. Reportedly, many of the victims of these loans are the elderly whose homes are paid off but who face difficulties living on a fixed income (dealing with, say, home repairs and car payments). They face the prospect of losing their homes to abusive lenders.

Response:

Representatives of mortgage brokers testified that the same loan terms can be abusive in one case but beneficial in another, and warned against defining a loan as "predatory" or abusive "simply based on the rate, points, or fees involved, or because the loan includes a feature such as a balloon, a prepayment penalty, negative amortization, or financing of closing costs". They argue that, "the abuse comes from the lender fraudulently deceiving the consumer through providing misleading or inaccurate disclosures, failing to accurately describe the loan terms, unfairly pressuring the consumer to take a loan, and/or failing to highlight the consumer's right of rescission. In many of these cases, the consumer has also failed to fully understand the terms and details of the loan or shop for a better deal". The mortgage brokers claim that only a small percentage of subprime loans are abusive and that "the great majority of subprime lending has expanded affordable credit for many people who otherwise would have none".

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■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.