

Appendix C

Report of the Task Force Committee on Policy Regulation
and Consumer Education

Sub-Committee Reports

Policy, Regulation & Consumer Education

The Policy, Regulation & Consumer Education Working Sub-Committee was formed to examine how existing laws, policies and consumer education initiatives can be adapted to address the issues confronted in the sub-prime problem as it faces Connecticut. This includes issues involving the public as well as regulatory issues facing the Department of Banking and the Department of Consumer Protection. While the scope of the report is largely limited to sub-prime lending, it should be noted that the issues in the report in most cases apply to all mortgage loans.

The sub-committee met on Thursday May 17, 2007, for an initial overview and discussion of the approach to be taken. The meeting concluded with identification of topics for further discussion and recommendation. At the conclusion of the second meeting on May 30, 2007, the group decided to focus on four core areas:

- Barriers to Entry
- Underwriting Guidelines
- Mortgage Fraud
- Foreclosure and Loss Mitigation

The law concerning Non-depository First Mortgage Lenders, Brokers and Originators is contained in Chapter 668 of the Connecticut General Statutes. When the law was first enacted in 1985 the barrier to entry into the mortgage industry was set low to encourage competition and consumer choice. Since this time, statutory changes have occurred bringing us to the present structure illustrated below. Barriers to entry, refers to lender and broker first and secondary mortgage license fees, surety bond requirements and tangible net worth requirements. To some extent, agencies can control the population of applicants by adjusting these barriers to entry. Connecticut's fees and barriers to entry are considered average in comparison with other states.

Barriers to Entry Current Requirements

Type of License	License Fee (2 yr period)	Net Worth Required	Experience Required	Surety Bonding Required
First Mortgage Lender	\$800	\$250,000	3 of last 5 years	\$40,000
Secondary Mortgage License	\$800	\$250,000	3 of last 5 years	\$40,000
First Mortgage Broker	\$400	\$25,000	3 of last 5 years	\$40,000
Secondary Mortgage Broker	\$400	\$25,000	3 of last 5 years	\$40,000
Mortgage Loan Originator	\$100		None	

Barriers to Entry Recommendations

1. Surety Bond Requirement

Under Connecticut banking law, a mortgage licensee is required to have a surety bond in the amount of \$40,000 to protect borrowers or prospective borrowers from a licensee's failure to perform its obligations.

The committee recommended that the current surety bond requirement for brokers and lenders be increased from \$40,000 to \$60,000, to adjust for inflation and current market conditions. While 31 states have lower bonding requirements of \$25,000 or less, the committee agreed that this increase would be appropriate to afford additional consumer protection.

Considerable discussion took place concerning the right to file a claim against a bond and the time within which the claim must be filed. In order to enhance the ability of the public and the Department of Banking to collect a claim made against the bond, the subcommittee recommended that consideration be given to using the type of surety bond currently used by the Department of Motor Vehicles (DMV).

2. Net Worth Requirement

Currently, the Department of Banking requires mortgage brokers and lenders to maintain a tangible net worth of \$25,000 and \$250,000 respectively. The committee recommended that the broker requirement be increased from \$25,000 to \$50,000 but that the lender requirement remain at \$250,000. After much discussion, the committee agreed that the \$25,000 threshold is not adequate to enter the mortgage brokerage business. By comparison, there are 38 states that presently require a mortgage broker net worth requirement of \$10,000 or less and 7 states that require tangible net worth of \$40,000 or greater.

The committee recommended that companies currently licensed be grandfathered over a 4-year phase in period. After that period, all licensees would need to meet the proposed new requirement.

3. Experience Requirement

Licensed mortgage lenders and brokers are required to have at the location for which the license is sought, a person with supervisory authority who has at least three years lending or brokerage experience as applicable, within the last five years. The committee agreed that this requirement should not be changed.

4. Background Checks

The committee recommended immediate expansion of background checks to include the use of Lexis Nexis Accurint system, on an interim basis. This will enable the Department of Banking to obtain national information on all applicants for licenses and originator registrations pending Connecticut's participation in the national mortgage licensing system.

Since 1985 the Connecticut Department of Banking has performed state background checks on individuals applying to be licensed in the mortgage industry. Unfortunately, since these checks only include Connecticut State Police records, if an applicant has a conviction in another state the file check will not show it. Accordingly, the committee's recommendation is particularly important in view of the fact that the mortgage business in large part is headquartered outside of Connecticut.

5. Training Required for Licensing

There are currently no requirements in the Connecticut General Statutes regarding training of lenders, brokers or originators either before or after they are licensed by the Department of Banking. The sub-committee felt strongly and recommends to the task force that training requirements be put in place for professionals in the mortgage industry that help individuals make what may be the largest investment of their lives.

The committee recommended the establishment of the following educational requirements for the person with supervisory authority and mortgage loan originators:

- Up to forty hours of pre-licensing training;
- Up to eighteen hours of continuing education, every two years, prior to license or registration renewal;
- A competency examination with a minimum passing score prior to obtaining a license or registration; and
- Exemption for current licensees from the initial forty-hour training requirement, provided they pass the competency examination.

Underwriting Guidelines

The committee agreed that existing underwriting guidelines should be revisited. The guidelines being used by non-bank mortgage licensees need to evolve to a safer standard in the interests of the public, the industry, and local and state economies. Contributing factors to the present problem with sub-prime lending is that lenders evaluate a borrower's ability to repay at the low introductory rate, rather than the fully indexed rate the monthly payment will increase to within two or three years. Policing underwriting standards would be micromanaging this industry, however, reform is necessary. It is the opinion of the Committee that guidelines be developed for underwriting instead of regulation or law because the standards change dynamically with the expansion and contraction of credit.

The Conference of State Bank Supervisors (CSBS) has done considerable work in developing guidance for both sub-prime lending as well as examination guidelines for state banking departments. Further, in November 2006, the Department of Banking sent to all licensees, a copy of the "Guidance on Non-traditional Mortgage Product Risks" developed by CSBS. In June 2007, the Interagency Guidance on Sub-Prime Lending was issued which listed characteristics of sub-prime ARM Products, elements of predatory lending and spelled out prudent underwriting guidelines. Nearly all of the underwriting issues discussed by the committee are addressed in these guidelines.

Underwriting Guidelines Recommendations

The following were the most important points discussed and were recommended by the committee:

- Qualify borrowers at the fully indexed rate of interest and payment to eliminate future payment shock;
- Include property taxes, homeowners insurance and condominium fees, if appropriate, in the debt – to – income ratio calculation;
- Base the loan approval on the borrower's ability to repay the obligation, not the value of the collateral property; and
- Use higher risk "stated income" loans only when there are mitigating factors to support the borrower's repayment capacity.

In addition, during July 2007, CSBS, The American Association of Residential Mortgage Regulators and The National Association of Consumer Credit Administrators adopted "Model Examination Guidelines" to be used during the supervisory examinations of non-bank lenders by each state. We suggest these also be sent to the industry and used by the Department in its supervisory role.

Low-Documentation and No-Documentation Sub-Prime Loans Recommendations

The committee recommended limiting the use of low-doc or no-doc loans. Prudent underwriting of loans takes into consideration the capacity of the borrower to repay the obligation, the credit rating, and the value of the collateral. Sub-prime lending puts less emphasis on good credit than does conventional underwriting. In many cases, risk increases when combined with low or no documentation loans, which often do not consider the income, assets, and/or employment of the borrower. An accurate and prudent assessment of the borrower's credit profile takes these factors into consideration. In the opinion of the committee, it is irresponsible to layer this much risk, either for the borrower or the lender, inasmuch as layered risks increase the chances of delinquencies and foreclosures.

Disclosure Recommendations

The mortgage closing process is complex and involves numerous and lengthy legal forms, disclosures and agreements. Consumers, in general, seldom understand all of the forms being signed and when consumers are unsophisticated or use English as a second language and are involved in a closing, they are at a distinct disadvantage. The committee acknowledges that the disclosure laws are generally under the purview of the federal government, however, the State of Connecticut could require simple language disclosures on one or two pages that would be "consumer friendly." The committee recommends consideration of the following:

- Simplify disclosures and put in language of borrower, if possible;
- Disclose the highest potential payment over the life of the loan;
- Disclose prepayment penalties and any other terms that will affect payments and payoff of any loan;
- Require that sub-prime borrowers' taxes and insurance payments are escrowed as part of the loan agreement;
- Recommend that each sub-prime borrower be required to have four hours of financial education provided by a housing advocacy agency; and
- Recommend that each sub-prime borrower that becomes 30 days past due during any introductory fixed rate or payment period, obtain two additional hours of financial counseling.

Mortgage Fraud Recommendations

There are basically two types of fraud in residential mortgage lending. First, in *fraud for housing* it is the consumer who is committing the fraud in order to obtain the mortgage financing. Second, *fraud for profit* may involve loan flipping schemes, equity skimming, or bait and switch tactics.

Although criminal fraud statutes exist and are generally applicable to fraud involving residential mortgages, the enactment of a Mortgage Fraud Statute would serve as a loud warning and deterrent to potential perpetrators of mortgage fraud. Accordingly, the committee recommended the enactment of a criminal mortgage fraud statute covering all perpetrators of mortgage fraud, who demonstrate criminal intent, including but not limited to lenders, brokers, attorneys, real estate agents and brokers, appraisers and borrowers.

Foreclosure/Loss Mitigation Recommendations

Foreclosures are personal, social and financial tragedies that affect not only those being foreclosed upon but the entire community. Foreclosures can add to urban blight, and lower property values.

One of the primary concerns is that consumers often do not know all of their options when they first become delinquent. Many delinquent borrowers facing foreclosure are reluctant to talk about their financial problems, or are unaware of their rights and obligations under the terms of their mortgage or under the judicial process. When borrowers are not able to make the full payments and lenders are not able to accept partial payments, the potential for mortgage foreclosures increases. Consequently, the committee recommends that additional emphasis be placed on financial education of sub-prime borrowers. Tools that educate borrowers and non-profit housing counselors on financial literacy such as CreditSmart®, a multi-lingual curriculum created by FreddieMac needs broader exposure. This program includes instruction on homeownership preservation, foreclosure prevention, planning for emergencies, property maintenance and avoiding financial traps.¹ The committee recommends the following:

- Connecticut should direct funding to housing advocacy agencies that can help resolve this sub-prime issue. It's vital that counseling be provided to these consumers, both before and possibly after the loan is granted.
- Permit an option to cure default by partial payments or to bring loan current².
- Establish a major publicity campaign for the "211" hotline. Governor Rell issued a press release on May 21, 2007, promoting the use of this resource.
- That the Department of Banking create a foreclosure hotline for impacted consumers.
- Provide increased state funding for housing counselors to work with borrowers facing ARM resets and foreclosures.
- Increase attorney participation in housing mortgage pro bono work by targeting retired and new attorneys
- Implement a lease-purchase program that could be done with a statewide housing development corporation or leveraged with an existing statewide entity. Terms of the agreement would be negotiated on a home-by-home basis to the satisfaction of both parties. The existing homeowner would be able to stay in the home, and, with some financial counseling, have the ability to regain financial control and repurchase the home a few years later. Purchases from the mortgagee would be made at a substantial discount to market value. If the homeowner cannot gain financial control and repurchase the home, the non-profit housing developer would hold the property and repair it. This would preserve the value of the property as well as neighboring properties.

¹ Boerger, Patti. "CreditSmart® now features homeownership preservation materials. FreddieMac, June 28, 2007

² The committee had not ascertained the legal implications of this recommendation, but agreed that it would help reduce foreclosures. In lieu of this requirement, one option would be to obtain the servicer's commitment to delay foreclosure for 30-60 days until the mortgagor can obtain assistance from a non-profit housing counselor to mitigate the loss with a possible loan modification.