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Lisa Madigan

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Testimony of

Illinois Attorney General Lisa Madigan

Testimony before the

Financial Crisis Inquiry Commission

Wednesday, January 14, 2010

Longworth House Office Building, Room 1100

Washington, DC

Hearing on

"The Causes and Current State of the Financial Crisis"

Mortgage Fraud Enforcement Actions by State Attorneys General

I. Introduction and Background

I want to thank the Commission for inviting me to discuss the law enforcement actions that I and my fellow state attorneys general have undertaken to address the foreclosure crisis, and to share my views on the causes of the financial meltdown. The states, as first responders, have embraced our traditional role of protecting our consumers during this crisis. We are the advocates consumers turn to when they have problems, the ones they call when they are losing their homes. We have seen up close the impact the financial crisis has had on families and throughout our country.

Multiple factors contributed to the near collapse of our financial system. Some of those factors and their relative significance remain open to debate. Although I do not purport to be an expert on all of the factors that were in play, I do believe that one fact on which we can all agree is that a crisis of global proportions began and remains rooted in our nation's devastated housing market.

To provide a sense of the devastation's scope:

- More than two million families have lost their homes to foreclosure since this crisis began in late 2006. Many more have lost their homes in short-sales or handed over their keys to their lenders and walked away. Another eight to 13 million additional homes are projected to go into foreclosure in the next five years.[1]

- So far, American taxpayers are on the hook for 500,000,000,000 dollars in direct payments and guarantees to the financial institutions that created this mess.[2] Only about $35 billion of that amount has directly benefitted distressed homeowners, in the form of funding for the federal Home Affordable Modification Program (HAMP).[3]

- With foreclosures still mounting, the HAMP program, which is supposed to permanently reduce troubled homeowners' monthly payments to affordable levels, is falling far short of its intended purpose. According to the most recent report, of the approximately 3.3 million homeowners who are eligible for the program, only about one million have been offered trial modifications and a mere 31,382 have received permanent modifications.[4]

- All homeowners, not just those trapped in unaffordable loans, have felt the impact of this crisis. Nearly 10.7 million homeowners are underwater in their mortgages, or, in other words, owe more than their homes are worth.[5] Roughly half those borrowers owe more than 120 percent of their home's value.[6]

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[1] TARP Congressional Oversight Panel, *December Oversight Report*: *Taking Stock: What has the Troubled Asset Relief Program Achieved?* (Dec. 9, 2009).
[2] TARP Congressional Oversight Panel, *Transaction Report for Period Ending January 4, 2010* (Jan. 6, 2010).
[3] *Id.*
[4] Making Home Affordable Program, *Servicer Performance Report through November 2009* (Dec. 10, 2009).
[5] "Home Values Plummet 500 Billion," *cnnmoney.com* (Dec. 9, 2009), available at http://money.cnn.com/2009/12/09/real_estate/home_value_loss/index.htm.
[6] *Id.*

- American homeowners lost an astonishing $3.6 *trillion* in equity in 2008, and are projected to have lost another $500 billion in 2009.[7] Illinois homeowners in Chicago were particularly hard hit last year, with home values falling by $49.6 billion.[8]

How did this catastrophe happen?

My testimony today will focus on the practices of a mortgage lending industry that careened out of control in the years preceding the financial meltdown. My testimony is based on what I have seen and learned in my tenure as the Attorney General and thus the chief consumer advocate for the state of Illinois. Since taking office seven years ago, in response to thousands of consumer complaints, I have investigated and ultimately brought enforcement actions against multiple players in the mortgage lending business, from independent brokers to some of the biggest lenders in the nation. These actions have permitted me to observe first-hand the practices and policies that drove lenders to push consumers into unsustainable, high-cost mortgages, in a mad rush to boost profits for participants up and down the chain of loan production.

Like many state attorneys general, I was bringing enforcement actions against predatory mortgage lenders long before Wall Street, or our national bank regulators, would even suggest that we had the makings of a disaster on our hands. The housing bubble may have officially burst in late 2007, but those of us on the frontlines of consumer protection have seen predatory lending practices since the late 1990s.

Federal Reserve Chairman Beranke recently acknowledged that the meltdown might have been averted if banks had been required by their regulators to assess each and every borrower's ability to repay their home loan. In the Chairman's words, "Stronger regulation and supervision aimed at problems with underwriting practices. . .would have been [an]. . . effective and surgical approach to constraining the housing bubble. . . ."[9]

The Chairman's concerns about poor underwriting standards and lax oversight, which he expressed this month, echo concerns that state attorneys general have been voicing for many years. The attorneys general not only voiced our concerns; we took action. In the past decade, we have sued numerous lenders for placing homeowners into loans they did not understand, could not reasonably afford, and could not get out of. In fact, poor underwriting practices are at the center of every major predatory lending action the states have brought, and every one of these actions is a matter of public record.

And yet, even in the face of mounting public evidence that the mortgage lending industry was abandoning common-sense underwriting standards, the federal regulators made no move to strengthen underwriting controls for the lenders under their direct supervision. I recall attending a meeting with federal regulators in 2006 at which I expressed my concerns about the oncoming crisis and the urgent need to implement tighter affordability standards for all home loans. At that

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[7] "One in Four Borrowers is Underwater," *Wall Street Journal* (Nov. 24, 2009), available at http://online.wsj.com/article/ SB125903489722661849.html.
[8] *Id.*
[9] "Lax Oversight Caused Crisis, Beranke Says," *New York Times* (Jan. 4, 2010), available at http://www.nytimes.com/2010/01/04/business/economy/04fed.html.

time, Wall Street was still making tremendous amounts of money on mortgage-backed securities. The federal regulators did not share my concerns.

In fact, in response to aggressive actions at the state level, federal regulators took unprecedented steps to shield national lenders and their subsidiaries from state enforcement and from the growing number of state anti-predatory lending laws on the books. The states have been leaders in enacting legislation to address the worst abuses in the mortgage industry. More than 30 states enacted laws to combat predatory lending in the six or seven years immediately preceding the meltdown.[10] In Illinois, for example, I have drafted and lobbied successfully for the passage of state legislation that provides significant homeowner protections at the point of sale. Those protections include ability-to-pay underwriting standards for all mortgage loans, severe restrictions on the use of stated-income or so-called "liar" loans, and the codification of a fiduciary duty between the mortgage broker and the borrower.

Unfortunately, the number of lenders who are subject to state predatory lending laws grew smaller as the doctrine of federal preemption expanded well beyond the established norms of sound legal doctrine. State enforcement authority was further diminished as the marketplace contracted and the remaining major mortgage lenders sought protection from state investigation and prosecution behind the shield of a national charter. Ultimately, my efforts and those of other state attorneys general were unable to fill the void created by what I view as an abdication of consumer protection and meaningful oversight at the federal level.

Even now, there appears to be a lack of will in Washington to fill the regulatory void that led to this crisis. Congress and the federal regulators have yet to put into place strict underwriting standards that apply to all home loans, even though the record shows that such standards are essential to preventing another crisis. Additionally, as seen in the ongoing battle over President Obama's proposed Consumer Financial Protection Agency, the big banks continue to lobby for the ability to operate within state borders without regard to state laws. As my testimony will make clear, the states were far more aggressive than the federal government in our efforts to curb growing abuses in the mortgage lending market *from the beginning*. The states therefore *must* be an integral part of any improved regulatory regime that is put into place to prevent a crisis of such catastrophic proportions from happening again.

My testimony is divided into two parts. First, I will summarize many of the enforcement actions brought by my office and the other state attorneys general against participants in the mortgage lending market who have engaged in mortgage fraud and other violations of consumer protection laws and regulations. This part will include a summary of my office's lawsuit against and settlement with Countrywide Home Loans, as well as an overview of my ongoing fair lending lawsuit against Wells Fargo. The second part of my testimony will discuss how the expansion of federal preemption and a lack of federal oversight of national lenders were primary factors that set the stage for this crisis.

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[10] Arthur Wilmarth, Jr., "Comptroller Dugan is Wrong About the Causes of the Financial Crisis and the Scope of Federal Preemption," *FinReg21* (Nov. 2, 2009), available at http://www.finreg21.com/lombard-street/comptroller-dugan-is-wrong-about-causes-financial-crisis-and-scope-federal-preemption.

II. Attorneys General Prosecution of Predatory Mortgage Lending Practices

Enforcement Actions

Famco, Household, Ameriquest

The state attorneys general are not newcomers to the arena of predatory lending. We have been pursuing these practices since 1998, when the states of Illinois, Massachusetts and Minnesota initiated civil suits against First Alliance Mortgage Company ("FAMCO"), a non-depository state chartered mortgage lender based in California. FAMCO was selling high cost loans to prime and subprime borrowers, and then bundling and selling those loans to the Wall Street firm Lehman Brothers. FAMCO's mortgage loans largely consisted of refinances into 2/28 ARM hybrid products. As a result of the litigation—which was subsequently joined by other states and the FTC—FAMCO was forced out of business and into bankruptcy. Pursuant to a settlement agreement in 2002, the government entities recovered well in excess of $50 million in restitution for consumers' losses. As this was at the beginning of the housing bubble, when borrowers were still building equity in their homes, many homeowners placed into unaffordable FAMCO loans could still refinance rather than go into foreclosure. The losses had not yet spilled over significantly into the larger marketplace.

While the FAMCO cases were still being settled, the attorneys general launched an investigation into the mortgage lending practices of the state chartered large subprime mortgage lender Household Financial based in Illinois. That investigation targeted many of the practices that bring us to this room today: Household engaged in a wide-scale pattern and practice of misrepresenting loan terms, selling loans with prepayment penalties and balloon payments without consumers' knowledge, packing credit insurance products into consumers' loans, refusing to give consumers loan payoff information, and writing loans that Household knew consumers could not afford. The multistate investigation of Household culminated in 2002 with a $484 million dollar restitution settlement and injunctive relief remedying the company's various fraudulent, deceptive, and unfair lending practices.

Not surprisingly, these predatory practices grew rampant throughout the subprime mortgage industry once the practice of bundling and selling off mortgages—including all liability for their soundness—became standard. And it soon became clear that there were problems with the largest subprime lender in the country at the time, the California-based lender Ameriquest. Ameriquest received its funding line from Wall Street firms. Those same firms bought and securitized the subprime loans Ameriquest sold. For those of us on the state level, the Ameriquest investigation marks the moment when we began to see the underwriting practices of mortgage lenders erode at a disturbingly accelerated pace. In 2002, Ameriquest was originating loans with an average loan-to-value ratio of 74 percent. Two years later, the ratio had risen to 81 percent. Ameriquest had also ramped up its originations of stated-income loans, that is, loans that permit the borrower merely to state his or her income without further review. By 2003, Ameriquest was originating almost 30 percent of its loans—which were all subprime—as stated-income or limited-documentation loans.

Our multistate investigation of Ameriquest revealed that the company engaged in the kinds of fraudulent practices that other predatory lenders subsequently emulated on a wide scale. These practices included: inflating home appraisals; increasing the interest rates on borrowers' loans or

switching their loans from fixed to adjustable interest rates at closing; and promising borrowers that they could refinance their costly loans into loans with better terms in just a few months or a year, even when borrowers no longer had any equity to absorb another refinance. Ameriquest also locked borrowers into unaffordable loans by including three-year prepayment penalties on loans with a two-year introductory rate that reset to a higher rate at the end of two years. Subprime lenders added these penalties because Wall Street investors preferred and paid more for loans that limited borrowers' chances of escaping after their rates exploded.

As a result of the multistate investigation, 49 states and the District of Columbia entered into a $325 million settlement agreement with Ameriquest in 2006. Just as important as monetary relief, the settlement contained extensive injunctive provisions that went to the heart of the industry's predatory lending practices. These provisions included: early disclosure of essential terms of the loan in an easily understood and concise manner, and the additional requirement that, if the terms changed, they would be re-disclosed prior to closing; scripts to be used during the sale of the loan informing borrowers about the essential terms of their loan; provisions ensuring that Ameriquest would deal at arms-length with appraisers; restrictions on placing prepayment penalties on hybrid ARMs, so that borrowers would not be trapped in loans when their interest rates reset upward; restrictions on serially refinancing borrowers; and requiring Ameriquest to use a pricing system that would provide the same rate to similarly situated borrowers.

The intent of the Ameriquest settlement was to create a lender code of conduct that would stem the rising tide of abuses in the subprime mortgage market. However, shortly after the settlement was finalized, the subprime mortgage market began to contract. Ameriquest went under, and the lender code of conduct was never fully implemented. Despite its ultimate failure, Ameriquest's climb to the top of the market had paralleled an explosive growth in subprime lending that irrevocably changed the economic landscape. Due to serial refinancing, many borrowers no longer had significant amounts of equity in their homes as of 2006. The days of what amounted to an elaborate equity-stripping scam were over, and equity-poor homeowners began defaulting in ever-increasing numbers.

Countrywide

By the fall of 2007, with the subprime mortgage market starting to crumble, my office knew that Countrywide Home Loans merited a closer look. At the time, Countrywide had grown into the largest prime and subprime mortgage lender in the nation. Countrywide was a state-licensed lender whose parent corporation also had a federal thrift subsidiary. In September 2007, my office, in conjunction with the California Attorney General's Office, sent subpoenas to Countrywide pursuant to our authority under our states' consumer protection laws. What we found as a result of those subpoenas, and from interviews with former employees and mortgage brokers, was that Countrywide, in relentless pursuit of greater market share, had engaged in a wide range of deceptive mortgage lending practices.

These practices included the erosion of underwriting standards, particularly through the use of stated-income loans to qualify borrowers for loans that they could not actually afford. We also found that Countrywide had engaged in a pattern and practice of qualifying borrowers at "teaser" interest rates in hybrid ARMs, as opposed to qualifying them at the fully indexed and fully amortizing interest rate, setting borrowers up for payment shock.

Countrywide also deceptively sold complex loan products with extremely risky features to borrowers who did not understand and could not afford them. The complexity of these products reached its peak in Countrywide's pay option ARM prime product, which allowed borrowers to make "minimum" payments that neither covered the interest that accrued on the loan each month, nor reduced the balance of the loan. After the amount of the loan exceeded the value of the home, borrowers were required to make a fully-amortizing payment that was significantly more than the minimum option, inevitably causing the borrower payment shock. Pay option ARMs were developed for sophisticated investors; they were never meant for mass sale. Additionally, we found that Countrywide structured unfair loan products with risky features, oftentimes combining several layers of risky features into one loan—for example, a stated-income 2/28 hybrid ARM with a loan-to-value ratio of over 95 percent, for which the borrower was qualified only at the initial teaser rate. This set borrowers up for unaffordable mortgage payments when their rates reset.

Furthermore, our investigation revealed that Countrywide's explosive growth was paralleled by the demand from the secondary market for loans with nontraditional risky features. Through the securitization process, Countrywide extracted hefty over-head charges, then shifted the risk of the failure of these non-traditional loans to investors. Moreover, securitization allowed Countrywide to tap those investors for much needed capital to fuel its origination process and reach its goal of capturing more and more market share. To facilitate the increase in loan origination volume, Countrywide relaxed its underwriting standards even more and sold risky, unaffordable and unnecessarily more expensive mortgage loans to millions of American homeowners.

In June of 2008, my office and the California attorney general sued Countrywide and its CEO Angelo Mozilo for multiple violations of our state consumer protection laws. On October 6, 2008, Illinois and several other states announced a settlement with Countrywide that established a first-of-its-kind mandatory loan modification program. The settlement, which 45 states have since joined, was designed to cover approximately 400,000 borrowers nationwide and is estimated to provide 8.7 billion dollars in loan modifications to borrowers. Countrywide will also pay approximately 150 million dollars into a foreclosure relief fund or for programs to help distressed homeowners.

Unlike previous settlements with subprime lenders, the Countrywide settlement did not contain mandatory injunctive provisions governing the company's future lending practices. There is a simple but disturbing reason for this. During our investigation, Countrywide transferred its mortgage origination business from its state-licensed subsidiary to its federally chartered thrift subsidiary, a move that potentially allowed the company to avoid state investigations of its practices and the enforcement of state laws.

Wells Fargo Fair Lending Lawsuit

In addition to suing predatory lenders for violations of our state's consumer fraud laws, I have focused on addressing the devastating effects of predatory lending on minority communities. This crisis was felt first in communities of color, its impact has been greater on communities of color, and its effects will be felt longer in communities of color. I ask that the Commission give proper weight to this fact in its findings.

In fall of 2007, the *Chicago Reporter*, after examining HMDA data from numerous major lenders, issued a study that found, among other findings, that African-American borrowers in the Chicago area were three times as likely as white borrowers to receive a high-cost home loan in the years directly preceding this crisis.[11] Variations in borrower income do not account for this disparity. During the bubble, African-American homeowners with six-figure incomes were more likely to receive high-cost loans than Asian-Americans, Latinos, and whites earning less than $35,000 a year.[12] Of the lenders examined in the report, Wells Fargo and Countrywide were the two top high-cost lenders in the Chicago area.

This report and my own investigation led me, in July of last year, to file a fair lending lawsuit against Wells Fargo, one of the nation's largest mortgage lenders. My complaint alleged that Wells Fargo illegally discriminated against African American and Latino homeowners by selling them high-cost subprime mortgage loans while white borrowers with similar incomes received lower cost loans. Wells Fargo established highly discretionary lending policies and procedures with weak oversight that permitted Wells Fargo's employees to steer African-Americans and Latinos into subprime loans. As described in the complaint, Wells Fargo's discretionary policies and procedures included a compensation structure that rewarded employees for placing borrowers into high-cost mortgages.

Additionally, as alleged in my complaint, Wells Fargo Financial Illinois, a subsidiary of Wells Fargo and Company that primarily sold subprime loans, engaged in unfair and deceptive business practices by misleading Illinois borrowers about their mortgage terms, misrepresenting the benefits of refinancing, and repeatedly refinancing loans, also known as loan flipping, without any real benefit to consumers. Also, Wells Fargo Financial used deceptive mailings and marketing tools to confuse borrowers as to which division of Wells Fargo they were doing business with—prime or subprime. As a result, borrowers believed they were doing business with Wells Fargo Home Mortgage, which offered mainly prime loans, when in fact they were dealing with Wells Fargo Financial, a predominantly subprime lender. At this time, the Wells litigation is ongoing.

In addition to the Wells Fargo action, my office launched a separate investigation into Countrywide Home Loans for potential violations of fair lending and civil rights laws. I have provided the results of my analysis to Countrywide and am currently in discussions with the lender about its conduct.

Actions Against State-Licensed Mortgage Brokers

It is important to note that very large lenders are not the only targets of my office's investigations and litigation. For the last few years, we have been investigating and prosecuting the many state-licensed participants in the market meltdown, especially mortgage brokers. Mortgage lenders used brokers as a third party sales force, but did little to monitor their activities. Instead, lenders incentivized brokers to sell the riskiest mortgage products. At the same time, lenders—who retained control of underwriting and final loan approval—failed to enforce prudent underwriting standards to ensure that borrowers were placed in loans that were affordable and appropriate for

[11] See *Chicago Reporter*, "An Equal Opportunity to Pay More," available at http://www.chicagoreporter.com /index.php/c/Web_Extras/d/An_Equal_Opportunity_To_Pay_More.
[12] *Id.*

their circumstances. Predictably, many mortgage brokers steered consumers into products that resulted in the highest compensation for the broker. My office found that many brokers utilized unfair and deceptive sales techniques to lure borrowers into expensive and risky loan products, placing the brokers' own desire for increased compensation above the duty to find suitable products for their clients. These findings are what led me to draft and lobby for the passage of an Illinois law codifying a broker's fiduciary duty to a borrower.

Enforcement Actions by Other States

The enforcement actions I have summarized above are by no means fully representative of the extensive efforts undertaken by my office or other state attorneys general to combat predatory mortgage lending in the lead-up to the crisis and in its wake. As a measure of the vast scope of state-level enforcement actions against predatory mortgage lenders in recent years, I offer the following, non-exhaustive list:

In May 2009, the Massachusetts Attorney General announced a settlement with Goldman Sachs, stemming from the office's investigation of the investment bank's role in originating and securitizing subprime loans in the state. In settlement of any potential claims against the bank, Goldman Sachs agreed to provide loan restructuring worth approximately $50 million to Massachusetts subprime borrowers.

Also, in October 2007, the Massachusetts Attorney General filed a civil fraud suit against the large California based subprime lender Fremont General for predatory lending practices. In that case, a Massachusetts court granted the Attorney General's request for an injunction that prohibited Fremont from initiating or advancing foreclosures on loans that are "presumptively unfair." The Attorney General was then given the opportunity to review the loans and object to any future advancement of the foreclosure process.

In June 2008, the Massachusetts Attorney General sued another large subprime lender, Option One Mortgage Company, and its parent H&R Block, for selling risky subprime products that were unaffordable and destined to fail.

In early 2007, the Ohio Attorney General filed a civil suit against the large California subprime lender New Century as the company prepared to file for bankruptcy. The Attorney General obtained a temporary restraining order prohibiting New Century from initiating any new loans or pursuing any foreclosure actions in Ohio. The injunction acted as a moratorium on New Century foreclosures in Ohio, thus giving the Attorney General's Office an opportunity to review the loans for evidence of predatory practices.

In December 2007, the New York Attorney General filed a civil suit against the nation's largest mortgage and property services company, eAppraiseIT, for inflating the value of home appraisals. According to the Attorney General, the scheme was a response to pressure from Washington Mutual. The inflated appraisals would allow Washington Mutual to write more loans for more money than the collateral would justify.

In a continuation of its investigation of appraisal fraud, the New York Attorney General announced in early 2008 that the nation's two largest purchasers of home loans, Fannie Mae and Freddie Mac, had entered into cooperation agreements requiring them to buy loans only from

banks that meet new standards designed to ensure independent and reliable appraisals. The agreements created a new organization to implement and monitor the new appraisal standards, known as the "New Home Valuation Protection Code."

The Connecticut Attorney General has sought to hold the major credit rating agencies accountable for their roles as enablers of this crisis. In 2008, the Attorney General separately sued three rating agencies, including Moody's, and late last year the office announced plans to file additional suits against Fitch and Standard & Poor's, among others.

In addition, numerous attorneys general have brought civil lawsuits against brokers, title companies and appraisers, including the attorneys general of Massachusetts, New York, Iowa, Ohio, and Colorado.

In sum, the state attorneys general have taken action against every participant in the crisis: appraisers, brokers, state and national lenders, CEOs, credit rating agencies, and the Wall Street investment banks that securitized toxic home loans. The next section of my testimony will address the question of what the federal regulators have done.

III. Assertions of Federal Preemption and Lack of Federal Oversight

As outlined in my testimony, the states have been aggressive in their pursuit of predatory lenders in the lead-up to the crisis and beyond. But our efforts increasingly placed us at odds with our counterparts in Washington. State enforcement actions have been progressively hamstrung by the dual forces of federal preemption and a lack of oversight at the federal level. In the lead-up to the meltdown, federal regulators often showed more interest in hampering state authority than in preventing the makings of a global crisis. The Office of the Comptroller of the Currency (OCC) was particularly zealous in its efforts to thwart state authority over national lenders, and lax in its efforts to protect consumers from the coming crisis.

In the last decade the OCC, which regulates the nation's largest banks, issued a series of rules that sought to prohibit states from enforcing a number of laws—including predatory lending statutes—against nationally chartered banks and even their non-bank subsidiaries. The culmination of this effort came in 2004, when the OCC issued sweeping preemption rules, based on dubious authority, which purported to overturn the well-established rule that federally chartered banks are subject to state law. The OCC's actions followed a similar preemptive course pursued by the Office of Thrift Supervision (OTS) since the 1990s.

The OCC's campaign to preempt states' authority over national banks could not have come at a worse time for consumers—or, as it turns out, for the nation's economy. The OCC's push came at a time when robust consumer protection, on both the state and federal levels, was needed more than ever: Subprime lending was growing at an exponential rate, and riskier and riskier loan products were beginning to flood the marketplace. What may seem like a case of unfortunate timing was no coincidence at all. The expansion of federal preemption was the product of a symbiotic relationship that benefited regulators and lenders alike. The OCC even emphasized preemption as an appealing reason for lenders to convert to a national charter.[13] By attracting

[13] Wilmarth, *supra*.

more fee-paying lenders, the OCC generated more revenues for their operating budget. In exchange, the growing number of lenders under the OCC's supervision had implicit authorization to expand their subprime offerings without fear of state prosecution.

National Bank Responsibility

On this point I want the record to be perfectly clear: National banks and their subsidiaries were major forces in creating the current financial crisis, despite their revisionist efforts to shift the bulk of the blame onto state-licensed entities. National banks were involved in the origination, funding, and securitization of risky loans. The statistics speak for themselves. National banks funded 21 of the 25 largest subprime issuers doing business in the lead-up to the crisis, as reported by the Center for Public Integrity.[14] Moreover, according to a recent study from the National Consumer Law Center, national banks, federal thrifts, and their operating subsidiaries were responsible for 31.5 percent of subprime mortgage loans, 40.1 percent of Alt-A loans, and 51 percent of pay-option and interest-only adjustable rate loans sold in 2006.[15] Also, let us not forget that federally-regulated financial institutions and holding companies were responsible for engineering the complex derivatives, such as mortgage-backed securities and credit default swaps, that fueled the nonprime lending spree.

As George Washington University Law School Professor Arthur Wilmarth, Jr., recently observed, "[F]ederally regulated institutions, including several of the largest national banks, were the primary private-sector catalysts of the current financial crisis."[16]

It also bears emphasis that, as the crisis was brewing, federal regulators did little to curb the abuses of the lenders within their control. For example, between 1995 and 2007, the OCC issued a total of 13 public enforcement orders against national banks for violating consumer protection laws, even as the agency was attempting to define itself as the sole protector of consumers doing business with national banks.[17] Given the proliferation of sophisticated and complex loan products in the marketplace, federal regulators should have taken steps in the last decade to ensure that lender underwriting standards protected consumers. Those standards should have included a requirement that lenders evaluate a consumers' ability to repay their mortgage loan, as required under various state laws.

The Federal Reserve had the unquestionable authority to tighten underwriting standards for all lenders under HOEPA. But instead of exercising its authority to protect consumers, the Federal Reserve focused almost entirely on safety and soundness, as did all federal regulators. One problem with this emphasis is that in recent years "safety and soundness" became synonymous with increased profits and asset growth. In turn, financial institutions increasingly relied on mortgage-backed securities and similarly risky financial instruments to boost their profits and growth.

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[14] Center for Public Integrity, "Who's Behind the Financial Meltdown?," available at http://www.publicintegrity.org/investigations/economic_meltdown/.
[15] National Consumer Law Center, "Preemption and Regulatory Reform: Restore the States' Traditional Role as 'First Responder'" (Sept. 2009).
[16] Wilmarth, *supra.*
[17] Wilmarth, *supra.*

Effects of Preemption on State Enforcement

In the absence of common-sense underwriting standards and basic consumer safeguards on the federal level, states found it extremely difficult to enact underwriting standards and other lending reforms for state-licensed entities. When we introduced legislation, mortgage brokers and other state licensees were quick to respond with the "level playing field" argument, demanding that they should be subject to the same lax standards as federal charters. Moreover, federal law expressly prohibits states from enacting laws restricting demonstrably risky features such as adjustable rates. As a result of these constraints, states had to rely on state consumer protection laws to regulate lending abuses. This approach proved difficult. It was not easy to prove that risky products and deceptive practices were illegal when there were no written federal rules or regulations specifically prohibiting them. Even as the mortgage market was collapsing, the states struggled to make the argument that the predatory practices and products which fueled the oncoming crisis were unfair and deceptive, because the federal regulators' refusal to reform those practices and products served as an implicit endorsement of their legality. When federal regulators finally and meekly weighed in with a joint Guidance on nontraditional mortgage products, it was too little, too late.

As a practical matter, the expansion of the preemption doctrine means that, when state attorneys general come upon lending abuses by federally chartered lenders, we first have to determine whether we can afford to expend our limited resources fighting a protracted preemption battle. Our efforts are further hampered by the fact that most of the remaining mortgage lenders are now sheltering under the protections of federal charters. A major lesson to be drawn from this crisis is that federal charters must *not* be viewed as giving lenders a blanket exemption from state prosecution for violating consumer protection laws.

IV. Recommendations and Conclusion

There is reason to hope that our nation has taken at least some of the lessons from this crisis to heart. The United States Supreme Court, in its recent *Cuomo vs. Clearinghouse*[18] decision, dealt a serious blow to the OCC's sweeping preemption rules and affirmed the right of states to hold national banks and their subsidiaries accountable for violations of fair lending laws. In fact, the *Cuomo* ruling green-lighted my decision to file a fair lending lawsuit against Wells Fargo. In doing so, I became the first state attorney general to sue a national lender for its role in creating this crisis.

Establish Strong Underwriting Standards for All Home Loans

The *Cuomo* decision is not the only indication that Washington is moving in the right direction. The Federal Reserve has recently taken some encouraging first steps toward remedying its past failures. Last year, the Fed finalized rules that require all lenders to evaluate a borrowers' repayment capacity in transactions involving home loans with certain features known to be high-risk. Unfortunately, these common-sense underwriting standards apply only to what the Fed has defined as "higher cost" loans. In light of the financial services industry's demonstrated talent for developing new products that evade regulatory reach, the Fed's definitional limitations are an invitation for trouble. It is not even clear whether the Fed's rules would apply to many of the

[18] *Cuomo v. Clearing House Assn., L.L.C,*, No. 08-453, 557 U. S. ____ (2009).

toxic pay-option ARM products that are helping to drive the current wave of foreclosures. I join with other consumer advocates in calling for strong underwriting standards that apply to *all* home loans.

Ban Yield Spread Premiums and Similar Forms of Broker Compensation

The Federal Reserve also recently proposed rules that would prohibit lenders from compensating mortgage brokers and in-house originators for bumping up the interest rates on loans or adding risky features. In the states' experience, this form of broker compensation, commonly known as a yield spread premium, played a pivotal role in driving sales of the toxic home loans that caused this crisis. Simply put, brokers were paid more by lenders for placing borrowers in loans containing the riskiest terms and features. Yield spread premiums and similar forms of compensation incentivized brokers to place borrowers into no-documentation loans, variable rate loans, and loans with prepayment penalties—all of which are known to increase the likelihood of failure.

Yield spread premiums created a perverse incentive to sell risky loans that were bad for borrowers, bad for investors, and bad for the economy. Last month, I co-drafted and filed comments with the Fed supporting the ban on Yield Spread Premiums and similar forms of compensation. Eighteen states have signed on to those comments.[19]

Establish Consumer Financial Protection Agency with Strong State Enforcement

But in the end, we cannot rely solely on the Federal Reserve or any single entity to safeguard our economy from a recurrence of this disaster. This crisis resulted from a cooperative failure at the highest levels of our financial institutions, regulatory system, and government. Its resolution depends on the willingness of every participant—federal and state, public and private—to commit to common-sense reforms. We must recognize that a dual state-federal regulatory regime, with consumer protection at its center, is vital to the health of our economy.

Coming to that recognition will be no easy task. As a nation, we have yet to reject the belief systems on which this crisis was founded. You need look no farther than Capitol Hill to see the signs of a future crisis in the making. The big banks are spending enormous amounts of money to defeat President Obama's proposal to establish a federal Consumer Financial Protection Agency, or CFPA. That bill would create a single financial regulator tasked with establishing and enforcing basic consumer protection rules applicable to *all* lenders and *all* consumer loan products. It would also permit state attorneys general to enforce those rules—and our own consumer protection laws—against all lenders, including national charters. The last time the national banks were granted broad exemption from state enforcement authority, we ended up with a global economic crisis on our hands. We must not let that happen again. I urge the Commission to strongly recommend that Congress pass President Obama's CFPA bill, with full state enforcement authority intact.

Thank you.

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[19] Those states are: Arizona, Colorado, Connecticut, Illinois, Iowa, Maine, Maryland, Massachusetts, Minnesota, Missouri, New Hampshire, North Carolina, Ohio, Rhode Island, Tennessee, Vermont, Washington, and West Virginia.