Testimony of
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Before

Subcommittee on Financial Institutions and Consumer Credit
U.S. House of Representatives Committee on Financial Services

"The Role of the Secondary Market in Subprime Mortgage Lending"

May 8, 2007

Madame Chairperson, Ranking Member Gillmor, Members of the Subcommittee, thank you for the opportunity to appear here today. I am Don Lampe, a partner in the Charlotte, North Carolina office of Womble Carlyle Sandridge & Rice, PLLC. I have been involved on behalf of industry trade organizations, mortgage lenders and others, either as a legal consultant or registered lobbyist, in the enactment of state and local high-cost home mortgage loan or so-called "predatory lending" laws in Georgia, Kentucky, Tennessee, Oklahoma, New Mexico, Ohio, Rhode Island, Minnesota and Montgomery County, Maryland. I have also counseled clients on the enactment and impact of these laws in North Carolina, California, Nevada, the District of Columbia, New Jersey, New York, Illinois, Massachusetts, Indiana, Wisconsin, South Carolina and Florida, as well as county and municipal ordinances across the country.

I have been requested to testify today on the following topics related to the secondary market and subprime mortgage lending:

- Is there a need for additional legislation?
- Specifically, how would the imposition of assignee liability affect the secondary market?
- Are there state experiences we can look to as examples?

I will address these issues in reverse order, and conclude that any additional action by Congress should be very carefully crafted so as not to discourage the funding of home loans that credit-challenged homeowners facing default or foreclosure may need more than ever in the coming months and years.

First, the threshold question: just what is meant by "assignee liability" in home mortgage lending? This Subcommittee and other bodies within the Congress have heard testimony on the "secondary market," which is the mechanism whereby residential mortgage loans are originated and then sold (sometimes, multiple times) into investment pools and ultimately to bondholders or noteholders. The bondholders or noteholders commonly are mutual funds, pension funds, private investment funds and individual investors – the same persons or entities that hold corporate bonds offered through Wall Street investment banks.

In short, "assignee liability" is a legal doctrine that imposes liability for legal violations committed by originators or "upstream" owners of residential mortgage loans, including securitization trusts and conceivably bondholders or noteholders. It is thought that "innocent" bondholders or noteholders, who are passive investors who had nothing to do with the origination of the loans, should not bear the same quantum of legal (and thus economic) risk as loan originators.* To conclude otherwise would be to upset investors' economic assumptions about risk and return and discourage a wide range of investors from providing funds (liquidity) for mortgage lending. There is no debate surrounding the premise that robust secondary markets, established by Fannie Mae, Freddie Mac, the Federal Home Loan Banks and private (non-agency) securitizers has contributed to the democratization of affordable home mortgage credit in the country.

Limitations on assignee liability in mortgage lending are not themselves unlimited. The "holder in due course" doctrine under the Uniform Commercial Code does not insulate noteholders (assignees) from all liability that a borrower may assert; assignees remain liable for all claims of which they have knowledge and for fraud, incompetency and lack of capacity, so-called "real" defenses. Under the Truth-in-Lending Act (TILA), assignees of real-estate secured loans generally are liable for any violations that are apparent on the face of the documents and are subject to rescission claims. The federal high-cost home loan law, HOEPA, imposes special enhanced assignee liability, by saying that assignees of HOEPA loans are liable for legal violations of the loan originator (creditor) *unless* the assignee is able to demonstrate that a "reasonable person exercising ordinary due diligence, could not determine, based on [required TILA disclosures] that the mortgage was a [HOEPA] mortgage. . ." 15 U.S.C. 1641(d). This enhanced assignee liability standard, and the way courts have interpreted it, is notable in its impact. Because of HOEPA's existing assignee liability rule, few, if any, HOEPA loans are sold

* Assignees and other noteholders ordinarily bear legal and economic risks of foreclosures. Even the broadest exculpatory statutes do not immunize loanholders from claims directly related to the conduct of foreclosure proceedings.

into the secondary market. The House of Representatives has had under consideration for a number of years expansion of the HOEPA law. If Congress follows this path, it very well could expand the types of loans that would be off limits to secondary market funding, making them virtually unavailable to borrowers. This result may well have an adverse impact on the very consumers that Congress is seeking to protect, credit-challenged borrowers who are not eligible for prime or conforming loans.

We all are aware that the states have served as "laboratories" for different approaches to curbing abusive or predatory lending practices. Beginning with North Carolina's ground breaking high-cost home loan enactment in 1999 (S.B. 1149), over 40 states and localities have enacted high-cost home loan laws. Legislatures in the states have faced the same issues that are before this body now – what role has the secondary market played in the growth of the nonprime mortgage market? Shouldn't Wall Street or the secondary market be liable for unlawful mortgage terms and practices? How can that liability be established and policed fairly and clearly, without denying legitimate loans to deserving homeowners? Our experience over the last five-plus years in the states shows that it is possible to overshoot the mark, such as occurred in Georgia and, to the lesser extent, other states, by over-regulating and effectively shutting down the secondary residential mortgage market. It is less clear, on the other side of the debate, whether the states have yet produced an example of well-balanced statutory provisions that protect consumers while preserving access to mortgage credit that consumers want and need.

The Georgia Fair Lending Act ("GAFLA") was put forward by consumer advocates and activist policymakers in Georgia as "the toughest predatory lending law in the nation." Indeed, this very toughness, especially as relates to assignee liability, may have been the law's undoing. As market participants studied GAFLA in advance of its effective date of October 1, 2002, it became evident that the law imposed absolute, unlimited liability on all purchasers, assignees or holders of "high-cost home loans" for the violation of *any* law, regardless of who committed the violation in connection with the origination of the loan. In effect, the secondary market shut down in Georgia, as secondary mortgage market participants observed:

- GAFLA imposed unlimited liability on anyone who made or took assignment of a home loan, including treble damages and attorneys' fees;
- No policies or procedures nor any amount of due diligence would limit an assignee's liability (unlike HOEPA and TILA). In effect, GAFLA established strict liability upon any assignee;
- The definition of "high cost home loan" was difficult to understand and apply, such that compliance-oriented lenders could not determine with any certainty whether a particular loan was in this undesirable class; and
- If *any* violation of law could result in unlimited liability upon an assignee, then no amount of compliance or due diligence could insulate a market participant from liability.

The "unintended consequences" of the original GAFLA are well known. Government-sponsored enterprises (GSE's) declined to purchase Georgia home loans (and not just high-cost home loans) originated after GAFLA, the rating agencies determined that they could not rate securitization transactions that contained post-GAFLA home loans, and investors ceased purchasing Georgia home loans. Ironically, because GAFLA's assignee liability provisions covered all home loans and all assignees, even non-profit and government agency-sponsored lending activities were curtailed in Georgia.

What happened next is instructive now. The Georgia General Assembly began work on an amendatory bill upon convening in January, 2003. The bill that emerged and became law in early March, 2003 (SB53/HCSFA), preserved the general assignee liability provisions in GAFLA but:

- Permitted an assignee or purchaser to prove that it exercised reasonable due diligence intended to prevent the purchaser or assignee from purchasing or taking assignment of high cost home loans. This is known, as it has been replicated in numerous other state "predatory lending" laws, as a diligence-based safe harbor;
- Limited affirmative causes of action against assignees or holders to individual actions, with damages capped at the remaining balance of the loan plus reasonable attorneys' fees;
- Preserved borrower actions against assignees or holders to enjoin foreclosure or obtain possession or assert defenses of recoupment or setoff; and
- Clarified that violations giving rise to assignee liability under GAFLA were for violations of that Act and not any law that could apply to a mortgage transaction.

As far as we know, the mortgage market in Georgia quickly returned to vitality. Since then, the Georgia General Assembly has addressed further issues in residential mortgage lending by enacting, *inter alia*, perhaps the strongest mortgage fraud law in the nation and strengthening the regulation of non-bank mortgage lenders and mortgage brokers.

What did we learn in Georgia and what have we observed in other states about market reactions to state laws? First, simply stated, it is possible for legislators to go too far. By now, in this Subcommittee, you are aware of the percentage of the overall residential mortgage market that relies on the efficient sale of mortgage loans to investors in order to provide homeowners with loan funds. Part of what lawmakers must contend with is that assignee liability itself is an arcane legal doctrine, an area where specific words and word formulas in statutes really matter. It is not surprising that a number of the proving grounds for new laws aimed at predatory lending did not get it quite right in these "experiments." In fact, several other states experienced adverse market reactions to new anti-predatory lending laws, including New Mexico, New Jersey and Indiana. In each of these instances, the state legislatures went back and amended troublesome provisions. We can and should learn from our experiences in these states.

Before the Georgia experience, state legislatures who adopted anti-predatory lending laws either remained silent on assignee liability (e.g., North Carolina, New York) or simply relied on existing federal law to establish the standards (e.g., Florida). Since then, a variety of state law approaches to the extent of and limitations on assignee liability in anti-predatory lending laws has emerged. *These laws impose liability on assignees or holders of high-cost home loans, but not on all residential mortgage loans.* Thus, these laws are aimed at nonprime mortgage lending and not at all mortgage loans. The more common provisions include:

- Absolute liability on assignees or transferees, with policy-based and diligence-based safe harbors, limitations on class actions and limits on individual damage recoveries, patterned after GAFLA as amended (Arkansas, Illinois, Indiana, Massachusetts, New Jersey, New Mexico and Rhode Island);

- Limitations on liability of holders-in-due-course (California) or of GSE's (Indiana, District of Columbia and Wisconsin); and
- Reliance on HOEPA, because the state laws track HOEPA (Ohio, Texas, Colorado and Maryland).

Is there a preferred approach to establishing assignee liability in a comprehensive federal law aimed at nonprime lending? Would this help alleviate the growing loss of homeownership due to increased defaults and foreclosures? Yes and no. Importantly, any federal law that begins with amendments to existing HOEPA likely will be freighted with HOEPA's effects. Hardly anyone, if anyone at all in the secondary market, funds or purchases HOEPA loans in secondary market transactions today. So, if Congress elects to amend HOEPA to cover more loans by expanding the loan types subject to the law or by lowering APR or "points and fees" thresholds or triggers, those loans in all likelihood will not be marketable in secondary market transactions. If Congress elects to expand HOEPA, it follows that Congress should amend the assignee liability provisions of that law. Using the states as an example, balanced, non-disruptive provisions that still provide consumers with meaningful recourse could include: (1) diligence-based safe harbors, which would encourage all secondary market participants to conduct adequate due diligence to confirm the types of loans being purchased and exclude loans with abusive or other unlawful features; (2) limitations on class actions, so that even if an "innocent" loan purchaser or investor inadvertently purchased an unlawful or abusive loan, the inadvertent violation would not result in unlimited monetary liability of secondary market investors; and (3) similarly, meaningful individual damage limitations, based on loan balances, payments made and/or other ascertainable dollar amounts.

Congress also would be well advised to observe carefully recent actions of federal and state regulators to curb mortgage lending abuses. These actions, intended to reduce the flow of capital to loan originators who do not pay close enough attention to the needs and capacities of individual borrowers, already having a pronounced impact on the offering of loans that may not be affordable. These actions include the promulgation of the Interagency Guidance on Nontraditional Mortgage Product Risks, which the financial institutions regulators finalized last fall. Through a unique partnership, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) soon after adopted the Guidance and recommend its passage by state financial regulators. To date, nearly thirty-five states have adopted the Guidance. In addition, the same federal regulators have issued a proposed Statement on Subprime Mortgage Lending, which is broader than the Guidance. The CSBS/AARMR coalition is expected to adopt this statement when it is finalized by the federal banking regulators. In conclusion, these initiatives are moving the mortgage market as a whole away from the lending terms and practices that contributed to current widespread numbers of defaults and foreclosures.

Borrowers who unwittingly obtained or had pressed upon them subprime mortgage loans that they did not understand and could not afford deserve opportunities to refinance out of those loans, as alternatives to foreclosure. Federal legislative activity that impairs the ability of nonprime borrowers to obtain new and potentially more favorable loans, as loans such as 2/28's and 3/27's mature and become payable in ever-increasing numbers, is not appropriate for these times. The solution could make the problem worse.

Again, thank you for having me here today. I am happy to answer any questions.

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Profile

Don Lampe is a member of the Firm's Regulatory, Compliance and Consumer Credit Practice Team within the Capital Markets Practice Group. He splits his time between the Charlotte and Greensboro, NC offices of the Firm.

His practice includes compliance counseling, administrative and legislative matters, product development (including electronic delivery and e-commerce), litigation and enforcement and complex financial transactions (such as RESPA joint ventures) for some of the nation's largest banks and bank holding companies, thrifts and thrift affiliates, insurance companies, finance companies, technology companies and other financial service providers, as well as trade groups and industry organizations. He has significant experience in government enforcement actions, serving as counsel to industry respondents in actions brought by state and federal regulators. He has written and lectured widely on current financial services topics such as financial privacy, federal preemption, fair lending and state consumer protection laws.

He has designed multi-faceted compliance programs involving consumer privacy, information security and electronic commerce. He has years of experience in matters of federal preemption and challenges of financial services providers posed by the interplay of federal and state laws. He regularly advises creditors, loan servicers, collection agencies and secondary market participants on multi-state licensing regulations and substantive credit regulations across the country. He has worked with banking and vendor clients over the years on regulatory and business aspects of payment systems, electronic funds transfers and deposit products. Recently, he has led teams of Firm attorneys as diligence counsel in a number of complex corporate acquisition and sale transactions.

For the last several years, he has been involved extensively in legislative and administrative initiatives on the state and federal level to regulate predatory lending, "payday" lending and other types of consumer financial products, as well as financial privacy. Don has served as counsel on high-cost mortgage lending issues to several national lending trade groups, as well as counsel to or registered lobbyist for state lending trade groups in North Carolina, Georgia, Kentucky, Tennessee, New Mexico, Oklahoma, Ohio and Minnesota. He is author of the "Georgia Fair Lending Act Compliance Toolkit" (published by the Georgia Bankers Association), the "Kentucky High-Cost Home Loan Compliance Toolkit" (published by the Kentucky Bankers Association), the "South Carolina High-Cost and Consumer Home Loans Act Compliance Toolkit" (published by FirmLogic, LP), and the "Ohio Homeowners Protection Act Compliance Toolkit" (published by Argus Growth Consultants).

Professional Activities

Bar Associations: American Bar Association, Chair, Consumer Financial Services Committee; Predatory Lending Task Force. North Carolina Bar Association: Real Property Section Council, 1997-2001; Business Law Section.

Fellow and Board of Regents, The American College of Consumer Financial Services Lawyers; Governing Committee, The Conference on Consumer Finance Law; Board of Advisors, UNC School of Law Center for Banking and Finance; Steering Committee, Mortgage Bankers Association of America State Legislative and Regulatory Committee; Legislative Research Commission of the North Carolina General Assembly, Credit Insurance and Mortgage Credit

Committee, 2000; North Carolina Secretary of State's URPERA Advisory Committee, 2004; Mortgage Bankers Association of the Carolinas Legislative Committee; North Carolina Bankers Association; "The Best Lawyers in America"; North Carolina Super Lawyer (Financial Institutions); Chambers USA Leading Lawyers (Financial Institutions); Duke University School of Law, Law Alumni Association Board of Directors, 1999-2002.

Admitted to the bar 1982, Texas; 1986, North Carolina.

Education
B.S., 1978, Massachusetts Institute of Technology, Phi Beta Kappa; J.D., 1982, Duke University School of Law, *Duke Law Journal*, Administrative Law Editor, 1981-1982, Staff Member, 1980-1982; Dean's Advisory Council.

Prior Legal Experience
Partner, Smith Helms Mulliss & Moore, LLP, Greensboro, North Carolina, October 1985-March 2002; Associate, Akin, Gump, Strauss, Hauer & Feld, Dallas, Texas and London, England, June 1982 & October 1985; Summer Law Clerk, Sidley & Austin, Washington, D.C., 1981; Summer Law Clerk, Akin, Gump, Strauss, Hauer & Feld, Dallas, Texas, 1980.

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