Joint Oversight Hearing of the
Senate Banking, Finance & Insurance Committee and
Senate Judiciary Committee

IMPLEMENTATION OF KEY FORECLOSURE-RELATED LEGISLATION: STATUS UPDATES AND RECOMMENDATIONS FOR FUTURE ACTION

March 16, 2010
1:30 PM, John L. Burton Hearing Room (4203)

Background

California is currently in the grip of a severe housing downturn, which has been driven by historically high rates of mortgage defaults and foreclosures. In the past three years, over 1.2 million California homeowners have received notices of default from their lenders. Over half a million California homes have been foreclosed upon. Housing values across the state have plummeted, and areas hardest hit by foreclosure have become blighted with vacant, uncared for homes.

While the earliest mortgage defaults and foreclosures were limited to risky sub-prime mortgages originated during the boom years of 2005 and 2006, California's high unemployment rate has caused defaults and foreclosures to spread to all types of loans, and to all types of borrowers. It is a rare individual in California who has not been personally affected by foreclosure. Virtually everyone has a friend or relative who is struggling to afford their mortgage, or who has lost their home to foreclosure.

The California Legislature has acted several times during the past three years, to enact legislation intended to respond to the ongoing foreclosure crisis. On Tuesday, March 16, 2010, the Senate Banking, Finance & Insurance Committee and Senate Judiciary Committee will jointly review the impact of five pieces of recent, foreclosure-related legislation.

Is the legislation being followed? Is it working? Should it be changed? Should it be extended? These questions, and others, will be addressed by a series of witnesses, representing the lending industry, consumer advocates, state regulators, local governments, tax professionals, and individual taxpayers.

I. Foreclosure Avoidance, Tenant Notice, and Anti-Blight Efforts: SB 1137 (Perata, Corbett, Machado), Chapter 69, Statutes of 2008; SBx2 7 (Corbett), Chapter 4, Statutes of 2009; ABx2 7 (Lieu), Chapter 5, Statutes of 2009.

Foreclosures in California are generally non-judicial, meaning that they are accomplished without court involvement. In order to initiate a nonjudicial foreclosure, the foreclosing entity must first file a Notice of Default (NOD). Although there is no requirement regarding the timing of an NOD, most beneficiaries usually wait at least three months following a borrower's delinquency before moving forward to record an NOD. State law requires the foreclosing entity to wait at least three months after filing an NOD, before it may move forward with a Notice of Sale. The law requires a notice of nonjudicial foreclosure sale to be officially noticed in a newspaper of general circulation, posted on the property, and recorded at least 20 days before the date of sale.

The nonjudicial foreclosure process, not including the SB 1137 or the SBx2 7 or ABx2 7 requirements, described below, could be completed in as few as 111 days, but may take significantly longer. According to Foreclosure Radar, the average length of time between recordation of an NOD and the sale of a property equaled 229 days in January 2010, up from 146 days in August 2008.

In an effort to help those for whom foreclosure may be avoided, the Legislature passed, and the Governor signed, SB 1137 (Perata, Corbett, Machado), and two identical bills, SBx2 7(Corbett) and ABx2 7 (Lieu). SB 1137 was an urgency bill, which was chaptered in July 2008 and applies its provisions through calendar year 2012. SBx2 7 and ABx2 7 were enacted in February 2009 and, as extraordinary session bills, took effect 90 days following their enactment. SBx2 7 and ABx2 7 both sunset on January 1, 2011.

a. SB 1137 (Perata, Corbett, Machado)

Since the beginning of the mortgage crisis, there has been a focus on the importance of encouraging the modification of loans to prevent avoidable foreclosures. The modification of those loans, when appropriate, helps keep homeowners in their homes, while generating income for the holder of the note. That mutually agreed upon solution avoids a potential foreclosure and the associated costs that foreclosure imposes on servicers, homeowners, and surrounding properties.

- **Mandatory contact at least 30 days prior to filing a Notice of Default**

With those principles in mind, SB 1137 required the lender or servicer of the loan to contact the borrower, or to try with due diligence to contact the borrower, at least 30 days prior to filing the NOD. Requiring lenders and servicers to contact borrowers before recording an NOD was intended to give the lender or servicer an opportunity to assess the borrower's financial situation and explore options that would allow the borrower to avoid foreclosure. SB 1137 also required that borrowers be advised of their right to request a subsequent meeting with the lender or servicer, and be provided with a toll free number to find a HUD-certified housing counseling agency. Unlike the tenant protections below, the contact requirements of SB 1137 apply only to loans originated between January 2003 and December 2007, which are secured by owner-occupied residential real property, where the borrower has not filed for bankruptcy, surrendered the property, or contracted with an entity to extend the foreclosure process. By facilitating early contact between borrowers and lenders, the bill sought to avoid unnecessary foreclosures and facilitate the modification or restructuring of loans in appropriate circumstances.

- **Tenant protections require additional notice prior to sale, and a 60 day notice prior to eviction after foreclosure**

SB 1137 also sought to address some of the issues facing tenants of foreclosed properties. Unlike owners who may have known for many months that the property was heading towards a foreclosure sale, tenants who are renting properties are generally unaware whether the mortgage on that property is paid, the home is at risk of foreclosure, or even whether the owner plans on walking away from his or her investment. Language barriers, and English only notices, further complicate the issue of notifying tenants when their rental home may be sold at a foreclosure sale.

To address some of those issues, SB 1137 provided that tenants must: (1) be mailed a statutory notice in six languages, which informs them that the foreclosure process has begun on the property they are renting; and (2) be given at least 60-days notice before they may be evicted after a foreclosure sale. Subsequent to the enactment of SB 1137, President Obama signed the Protecting Tenants at Foreclosure Act of 2009, P.L. 111-22, which further required that tenants of foreclosed homes receive a 90-day notice to vacate. In addition, that Act generally requires the purchaser of a home at a foreclosure sale to honor the tenant's lease, unless the purchaser intends to occupy the home as their primary residence.

- **Anti-blight provisions**

There are many negative side effects that a foreclosure can have upon a community, including the possibility that the property will be vandalized by the borrower who was unable to avoid foreclosure, or that a vacant property will fall into disrepair, attract vandals, and pose a health and safety risk. Deteriorating, blighted properties may also depress surrounding property values.

In response to those concerns, SB 1137 required legal owners to maintain vacant residential properties that were purchased at a foreclosure sale. SB 1137 defined "failure to maintain" as the failure to care for the exterior of the property, including, but not limited to, permitting excessive foliage growth that diminishes the value of surrounding properties, failing to take action to prevent trespassers from remaining on the property, failing to take action to prevent mosquito larvae from growing in standing water, or other conditions that create a public nuisance.

To enforce that maintenance requirement, government entities were given the authority to impose a civil fine of up to $1,000 per day per violation. Under the provisions of SB 1137, government entities are required to provide notice of their intent to impose a fine, if corrective action is not commenced within 14 days and completed within 30 days. Those anti-blight provisions sought to encourage the repair of foreclosed homes, while providing a penalty should residences not be repaired in the time allowed.

b. SBx2 7 (Corbett) and ABx2 7 (Lieu), the California Foreclosure Prevention Act

Enacted in a special session of the Legislature, SBx2 7 and ABx2 7 (collectively known as the "7s"), enacted the California Foreclosure Prevention Act to "to provide additional time for borrowers to work out loan modifications while providing an exemption for mortgage loan servicers that have implemented a comprehensive loan modification program." Specifically, the 7s added 90 days to the nonjudicial foreclosure process. The bills allowed servicers to apply for an exemption from this 90-day delay, by demonstrating to the appropriate commissioner that the servicer had implemented a comprehensive loan modification program. Servicers desiring an exemption must apply to the Departments of Corporations, Real Estate, or Financial Institutions.[1] Exemption from that 90-day delay may be granted by a commissioner through either a temporary or final order. Temporary orders are issued upon a commissioner's receipt of the initial application for exemption, and are in effect until either a final order is issued or until 30 days after the denial of an application.

In order for a servicer to qualify for a final order of exemption, its comprehensive loan modification program must:

- Intend to keep borrowers whose principal residences are homes located in California in those homes when the anticipated recovery under the loan modification or workout plan exceeds the anticipated recovery through foreclosure on a net present value basis.
- Target a ratio of the borrower's housing-related debt to the borrower's gross income of 38 percent or less, on an aggregate basis in the program.
- Include some combination of the following features:
    - An interest rate reduction for a fixed term of at least five years.
    - An extension of the amortization period for the loan term, to no more than 40 years from the original date of the loan.
    - Deferral of some portion of the principal amount of the unpaid principal balance until maturity of the loan.
    - Reduction of principal.
    - Compliance with a federally mandated loan modification program.
    - Other factors that the commissioner determines are appropriate. In determining those factors, the commissioner may consider efforts implemented in other jurisdictions that have resulted in a reduction in foreclosures.

The 7s also gave the commissioners authority to revoke a final order if a servicer submits a materially false or misleading application, or if the approved loan

[1] The Commissioner of Financial Institutions is responsible for banks, savings associations and credit unions organized in this state servicing mortgage loans; the licensed real estate brokers servicing mortgage loans are covered by the Real Estate Commissioner; and the Commissioner of Corporations is responsible for the remaining lenders, servicers, and brokers servicing mortgage loans.

modification program is materially altered from the program on which the exemption was based. The commissioners, within existing resources, were also required to collect data regarding loan modifications accomplished pursuant to the Act and make that data available on a web site at least quarterly.

The most recent set of data from the fourth quarter of 2009 reported that while 193,263 workouts were initiated, only 77,919 workouts closed. Of those workouts "closed", the greatest percentage consisted of HAMP trial loan modifications[2], followed by non-HAMP permanent loan modifications, and repayment/forbearance plans. The data included in the report came from the Departments of Corporations and Real Estate. A copy of the full report can be downloaded from the Department of Corporation's web site (http://www.corp.ca.gov/FSD/CFP/default.asp).

The 7s further required the Secretary of Business, Transportation and Housing ("Secretary") to submit reports to the Legislature regarding the details of actions taken to implement the Act and the numbers of applications received and orders issued. The Secretary was also required to maintain a web site that lists the final orders of exemption, the date of each order, and a link to the web site describing the loan modification programs.

The California Foreclosure Prevention Act sunsets on January 1, 2011.

II. SB 94 (Calderon, Steinberg, Corbett), Chapter 630, Statutes of 2009

By late 2008, it had become apparent that tens of thousands of California borrowers were having trouble affording their mortgages, and were facing default, and possible foreclosure, if they were unable to negotiate a loan modification or other form of loan forbearance or forgiveness from their lender. A cottage industry had sprung up to exploit these borrowers, prey on their fears of foreclosure and their ignorance of the options available to them, and charge them fees (often up-front, nonrefundable fees) for services these borrowers could obtain elsewhere, free-of charge. Unscrupulous individuals seeking to take advantage of troubled borrowers could be found outside every mortgage fair, trying to drum up business. Their advertisements abounded in neighborhoods that had been hardest hit by foreclosure.

In January 2009, SB 94 was introduced, to prevent any person or business from charging an up-front fee to a borrower for helping negotiate a loan modification or other form of mortgage forgiveness or forbearance on that borrower's behalf. SB 94 allowed fees to be collected by those who offered foreclosure avoidance services, but required all agreed-upon services to be performed, before the fee could be collected.

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[2] HAMP stands for the "Home Affordable Modification Program." HAMP, part of President Obama's Homeowner Affordability and Stability plan, seeks to help at-risk homeowners to avoid foreclosure by reducing monthly payments to no more than 31% of their gross monthly income.

SB 94 also required those who sought to charge borrowers a fee for helping negotiate a loan modification or other form of mortgage forgiveness or forbearance to clearly inform borrowers that similar services were available from non-profit housing counselors, free of charge. If a borrower was being solicited in a language other than English to pay for loan modification services, SB 94 required the notification described immediately above to be provided in the language in which services were being marketed.

The provisions of SB 94 applied equally to attorneys and real estate licensees, to address concerns that had been raised about unscrupulous loan modification activities being conducted by some members of these professions. The bill was supported by the California Association of Realtors and the California State Bar, among several other groups. SB 94 was enacted on an urgency basis, and became operative on October 11, 2009.

In the time since the bill's enactment, both the Department of Real Estate (DRE) and the State Bar have posted considerable information about the bill for their licensees on their web sites, including detailed answers to Frequently Asked Questions. DRE has also provided translations of the required notification into five foreign languages, which may be downloaded from its web site (http://www.dre.ca.gov/ind_loanmoddisclosure.html). Both DRE and the State Bar have taken a significant number of enforcement actions against unscrupulous loan modification service providers.

III. SB 1055 (Machado), Chapter 282, Statutes of 2008

Under existing state tax law and prior federal tax law, mortgage principal forgiven by a lender is taxable to the borrower as ordinary income (not capital gains) in the year in which the debt is forgiven. In December 2007, the federal government acknowledged the burden this tax treatment could cause borrowers who were already having trouble meeting their financial obligations by enacting HR 3648, P.L.110-142. Under that federal law, taxpayers whose lender forgave mortgage principal on the taxpayer's principal residence could exclude that forgiven debt from their incomes for purposes of their federal taxes. HR 3648 authorized its tax relief for the 2007, 2008, and 2009 tax years.

California enacted similar legislation in 2008 (SB 1055, Machado, Chapter 282, Statutes of 2008). However, in recognition of the state's significant budget shortfall, SB 1055 was only effective for the 2007 and 2008 tax years. The bill also capped the amount of debt that each taxpayer could exclude from their state taxable income at $250,000 (versus a $2 million cap under federal tax law).

Borrowers in at least four types of situations benefited from the relief in SB 1055: 1) borrowers who lost refinanced homes to foreclosure; 2) borrowers who negotiated loan modifications with their lenders, in which the lender agreed to reduce the principal of the loan; 3) borrowers whose lenders agreed to a short sale; and 4) borrowers whose lenders agreed to accept a deed in lieu of foreclosure.

When it analyzed SB 1055 in 2008, the Franchise Tax Board estimated that the bill would help at least 7,500 taxpayers over the two year period it would be in effect.

In October 2008, the federal government extended its mortgage debt forgiveness income tax relief through tax year 2012 (HR 1424, P.L. 110-343). Federal action in this area reflected a belief that the nation's mortgage troubles would likely linger for several more years. To date, the state's attempts to conform to the changes enacted by HR 1424 have failed. Bills that would have extended this treatment have either been held in committee (e.g., SB 97 (R. Calderon) and AB 111 (Niello)) or vetoed (AB 1580 (C. Calderon)).

Unless California acts to conform to federal law, California borrowers will not be entitled to tax relief on forgiven mortgage debt for 2009, or any later tax year. Without this tax relief, staff estimates that as many as 150,000 taxpayers could be forced to pay taxes on forgiven mortgage debt on their 2009 state tax returns (estimates derived using foreclosure and short sale statistics provided by the California Association of Realtors and Foreclosure Radar).