September 28, 2010

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed a proposed statutory initiative related to mortgage loan modifications and "short sales" for residential real property (A.G. File No. 10-0021).

BACKGROUND

Loans Used to Purchase Most Residential Real Property. Loans to purchase residential real property, such as single-family homes or apartments, are secured by either a mortgage or a deed of trust. Individuals often use mortgages to purchase residences such as a home or a nonowner-occupied residence, while companies or groups use deeds of trust to secure nonowner-occupied residential property. Mortgages or deeds of trust secured by residential property may be used as collateral that gives the lender the authority to foreclose and sell the property if the borrower fails to pay back the loan.

Due to the recent recession, many residential property owners are having trouble making payments on their loans. Under current law, if a borrower requests a change to the loan because he or she is having trouble making loan payments, lenders may voluntarily take actions such as modifying or rewriting mortgage loans, or accepting the sale of a property for less than the balance owed on the loan (also known as a short sale). In many cases where an owner is having trouble making loan payments, the total amount owed on the loan is more than the fair market value of the property. (This is commonly referred to as being "upside down" on the property.) Information about loan modifications and short sales typically appears on a consumer's credit report.

Many Types of Residential Property Loans. A number of different types of mortgage loans are available. Among these are negative amortization and option adjustable-rate mortgage (ARM) loans. Negative amortization occurs when a loan payment is less than the interest charged, which causes the outstanding balance of the loan to increase. Option ARM loans have interest rates that move up or down at some point in time due to changes in the market.

In addition to the first mortgage that may be used for the purchase of a home or an apartment complex, there may be other additional loans on the property, such as home equity loans or second mortgages. These use the difference between the value of the property and the unpaid mortgage balance to secure another loan against the property. The monies borrowed through these loans may be used by residential property owners to pay for major expenses, such as repairs to the property.

Regulation of the Mortgage Loan Industry. In California, the Departments of Corporations, Financial Institutions, and Real Estate regulate different facets of the mortgage loan industry. Some financial institutions—mainly banks and savings and loans—are regulated by the state and some by federal agencies. Federal regulations require all of these financial institutions to report certain information about loans and loan modifications to the state departments and federal agencies that regulate the industry. Federal regulations further prohibit reporting of inaccurate information to consumer reporting agencies.

State and Federal Constitutions Prohibit Changes to Existing Contracts. In addition to the laws that regulate the mortgage loan industry, the U.S. Constitution and the State Constitution prohibit the enactment of laws that interfere with or change the terms of existing contracts.

PROPOSAL

Major Provisions. This measure enacts a new state statute that is intended to ensure that borrowers using certain types of mortgage loans secured by residential property can obtain a loan modification or short sale under specific conditions. The provisions of this measure would apply to the first mortgage or deed of trust for residential property where the loan on the property was either a negative amortization loan or an option ARM loan and the owner was upside down on the property.

As discussed below, some provisions of this measure differ for owner-occupied and nonowner-occupied residential property. Some other provisions apply the same rules for the two different types of residential property.

Lenders Must Consent to Loan Modifications. Under this measure, if the owner of either an owner-occupied or nonowner-occupied residential property requests that the mortgage be converted into a 30-year fixed loan, the lender must consent to such a loan modification. The property owner could make such a request at any time. The amount of the new loan that the lender would have to make would be limited. Specifically, it may not exceed the combined total of (1) the fair market value of the property and (2) any additional money that was borrowed against the property, such as for a home equity loan, except money that was used for property improvements. For example, in a case where the current fair market value of the home is $200,000, and a second mortgage was taken in the amount of $20,000 to buy a car, the amount of the new 30-year fixed-rate loan would be $220,000. The measure would also require that the modification to the first mortgage “extinguish” all other mortgages so that the property owner would owe nothing more on them.

Some Lenders Must Consent to Short Sales. Under this measure, if the owner of a nonowner-occupied residential property requests a short sale, the lender must consent and allow the property to be sold for less than the amount owed as payment in full on the loan. This provision would not apply to owner-occupied residential property. If the obligation of the loan is satisfied by a short sale, the lender must extinguish all other mortgages that are secured by the property and, again, the property owner would owe nothing more on them.

Other Provisions. This measure states that it would apply to mortgage contracts and deeds of trust for residential property that were entered prior to, on, or after the passage of this measure. This measure also provides that, if a loan modification or a short sale occurs as a result of this measure, this information may not be reported to any consumer credit reporting agency and may not reflect negatively on a person's credit report.

FISCAL EFFECTS

In theory, this measure could have several fiscal effects on state government. However, the actual fiscal effects of this measure are probably insignificant mainly because its key provisions would conflict with the U.S. Constitution and the State Constitution, as well as federal regulations.

Theoretical Fiscal Impacts. Theoretically, this measure could reduce the amount of revenues that the state receives from its corporation tax. The loan modifications and short sales required by this measure could potentially reduce the interest and principal payments that borrowers would otherwise make to lenders. This could result in lower profitability of lenders and, as a result, reduce the amount of corporation taxes these financial institutions pay to the state.

Actual Fiscal Effects Probably Insignificant. As noted earlier, this measure contains a provision that is intended to apply this measure retroactively to existing loans on residential property. However, as we also noted earlier, the U.S. and State Constitutions prohibit the state from enacting any law that interferes with or changes the terms of existing contracts. Therefore, it is unlikely that this statutory provision could apply to contracts that were entered into prior to its passage. The provisions of this measure could in theory apply to loan contracts that were entered into after its passage. However, it is likely that the enactment of this measure would deter lenders from making negative amortization or option ARM loans in the future that would be subject to its provisions. Because of the recent tightening of lending standards, the number of negative amortization loans and option ARM mortgage loans has already significantly diminished.

Likewise, it is unlikely that the provision of this initiative to prohibit the reporting of loan modifications and short sales to credit agencies would be effective. Federal regulations would continue to require mortgage lenders to report such information to credit agencies.

For all of these reasons, the practical effect of this measure, and thus its effect on state corporation tax revenues, is likely to be insignificant. Also, we did not identify any specific fiscal impacts from this measure on local government.

SUMMARY

Our analysis of the fiscal effects of this measure is as follows:

- The fiscal effect of this measure on state and local government is probably insignificant.

Sincerely,

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Mac Taylor
Legislative Analyst

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Ana J. Matosantos
Director of Finance