HOUSE COMMITTEE ON FINANCIAL INSTITUTIONS

TEXAS HOUSE OF REPRESENTATIVES

INTERIM REPORT 2008

BURT SOLOMONS

CHAIRMAN

COMMITTEE CLERK

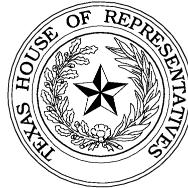
LESLEY FRENCH

COMMITTEE ON FINANCIAL INSTITUTIONS

TEXAS HOUSE OF REPRESENTATIVES
P.O. BOX 2910 • AUSTIN, TEXAS 78768-2910
CAPITOL EXTENSION E2.104 • (512) 463-0778

BURT SOLOMONS
CHAIRMAN

DAN FLYNN
VICE CHAIRMAN



November 1, 2008

The Honorable Tom Craddick
Speaker, Texas House of Representatives
Members of the Texas House of Representatives
Texas State Capitol, Rm. 2W.13
Austin, Texas 78701

Dear Mr. Speaker and Fellow Members:

The Committee on Financial Institutions of the Eightieth Legislature hereby submits its interim report for consideration by the Eighty-First Legislature.

Respectfully submitted,

Burt Solomons, Chair

Rep. Dan Flynn, Vice-Chair

Rep. Norma Chavez

Rep. Rafael Anchia

Rep. Doc Anderson

Rep. Brian McCall

Rep. Rob Orr

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INTRODUCTION

At the beginning of the 80th Legislature, the Honorable Thomas "Tom" Craddick, Speaker of the Texas House of Representatives, appointed seven members to the House Committee on Financial Institutions (the Committee). The Committee membership included the following appointees: Burt Solomons, Chair, Dan Flynn, Vice-Chair, Norma Chavez, CBO, Rafael Anchia, Doc Anderson, Brian McCall and Rob Orr.

During the interim, Speaker Craddick assigned the Committee on Financial Institutions the following charges:

1. Monitor federal rules and regulations on lending and determine the state's role in regulating issues that relate to the mortgage foreclosure process, disclosures for loan terms, home equity, mortgage brokers, mortgage bankers, consumer protections, and counseling for mortgage products.

2. Monitor the implementation of HB 716, 80th Legislature, Regular Session, to determine if there is a need to further legislate the protection of homebuyers in mortgage fraud schemes, emphasizing the impact in the foreclosure process.

3. Study the adequacy and effectiveness of existing regulation of prepaid funeral benefits that are funded by insurance or annuity products and make recommendations for statutory changes necessary to further strengthen the regulatory system for protecting consumers.

4. Study practices involved in the sale and financing of a motor vehicle, including conditional delivery, negative equity, and retirement of existing debt on vehicle trade- in.

5. Study whether the state financial regulatory agencies should assist consumers in the investigation and correction of credit card billing errors.

6. Assess the extent of consumer protections in state regulations of short-selling of commodities, with a particular emphasis on the state's enforcement authority and ways to ensure reliability in the short-selling market.

7. Examine the practice of marketing variable annuities and determine whether certain sales practices constitute fraud.

8. Monitor the agencies and programs under the committee's jurisdiction.

The Committee met in three public hearings, held on January 23, 2008, April 2, 2008 and June 11, 2008. The Committee would like to express its appreciation to Acting Commissioner Bob Bacon and staff at the Texas Department of Banking, Commissioner Leslie Pettijohn and staff at

the Texas Office of the Consumer Credit Commissioner, Commissioner Harold Feeney and staff at the Texas Credit Union Department, Commissioner Doug Foster and staff at the Texas Department of Savings & Mortgage Lending, Executive Director Robert Kline and staff at the Texas Bond Review Board, and Executive Director Kimberly Edwards and staff at the Texas Public Finance Authority for their continued work to keep the Committee informed on important matters in their respective areas of authority.

The Committee would also like to express its appreciation to the following state government employees, industry representatives, consumer representatives and interested public citizens who testified before the Committee and contributed to the interim process:

Former Commissioner Randall James, Everett Jobe, Stephanie Newberg & Russell Reese (Texas Department of Banking), Alan Bush (Federal Deposit Insurance Corporation), David Glicker & James Daross (Texas Attorney General's Office), Tim Irvine (Texas Real Estate Commission & Texas Appraiser Licensing & Certification Board), Rudy Aguilar (Office of Consumer Credit Commissioner), Betsy Loar (Texas Credit Union Department), Commissioner Mike Geeslin, Dennis Pompa & Christopher Bean (Texas Department of Insurance), Karen Neeley, Steve Scurlock & Joe Collins (Independent Bankers Association of Texas), Chet Robbins (Texas Funeral Services Commission), Brett Bray (Texas Department of Transportation), Bill Stutts, Denise Davis & Judith Ross (Baker Botts), Lori Levy (Texas Association of Realtors), Larry Temple (Texas Mortgage Bankers Association), JoAnn DePenning (Texas Foreclosure Prevention Task Force), Gary Maler & Dr. James Gaines (Texas Real Estate Center), Robert Doggett (Texas Low Income Housing Information Service), Everett Ives (Texas Association of Mortgage Brokers), Roland Love (Texas Land Title Association), Todd Mark (Consumer Credit Counseling Service of Greater Dallas), Robert Power (Countrywide Financial Corporation), Pablo Schneider (Hispanic Alliance For Progress Institute), Paul Beaty (Texas Funeral Directors Association), Mike Pollard (Texas Association of Life & Health Insurers), Kris Seale (Funeral Directors Life Insurance Company), Karen Phillips (Texas Automobile Dealers Association), Don Schwent (Enterprise Rent-A-Car), Ron Williams (Texas Association of Local Housing Agencies), Dan Donohoe (JPMorgan Chase), Martin Sisk, Norma Minnis & Connie Hearn (Dallas/Ft Worth Association of Mortgage Brokers), John Fleming, James Ratliff, Connie Rowe, Joe Mann, Susan Thomas & Patricia Logsdon.

Finally, the Committee staff would like to thank the Chairman's staff members that assisted with the hearings and editing of this report - Kari Torres, Kathy Carrington, Robert Orr and Bonnie Bruce.

HOUSE COMMITTEE ON FINANCIAL INSTITUTIONS

INTERIM STUDY CHARGES

Monitor federal rules and regulations on lending and determine the state's role in regulating issues that relate to the mortgage foreclosure process, disclosures for loan terms, home equity, mortgage brokers, mortgage bankers, consumer protections, and counseling for mortgage products.

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Study whether the state financial regulatory agencies should assist consumers in the investigation and correction of credit card billing errors.

Assess the extent of consumer protections in state regulations of short-selling of commodities, with a particular emphasis on the state's enforcement authority and ways to ensure reliability in the short-selling market.

Examine the practice of marketing variable annuities and determine whether certain sales practices constitute fraud.

Monitor the agencies and programs under the committee's jurisdiction.

MORTGAGE LENDING & FORECLOSURES

Background

Since August 2007, a person cannot view any news report or media source without seeing the effects of the subprime housing problems affecting the national real estate market and economy. From homeowners to taxing entities, this resulting credit crunch has Americans worried about their finances while the experts review the causes and outcomes of the current lending process.[1]

While the Texas housing market continues to be strong, the recent national trends show increased foreclosures, rising interest rates, reduced home value appreciation, and unaffordable mortgage payments. These issues present challenges for Texas and its mortgage lending industry.[2]

The concern of this interim charge is: What is the source of current real estate market problems and how will Texas fare?

Mortgage Lending Products

The financial market has numerous lending products to offer to consumers. A person can finance anything from a house to a car to furniture. Prime lenders (banks, thrifts and credit unions) typically offer loan products to borrowers with the best credit ratings. Traditionally, a prime mortgage loan involves a buyer putting 20 percent of the value of the home down as collateral for the 80 percent loan they need to purchase the home. However, new products and incentives have made it possible to purchase a home without any down-payment payment.

From the late 1990s until mid-2007, the economy was supported by a vibrant housing market and strong consumer spending. New products became available and provided an important gateway for people wanting to purchase a home. These products include adjustable rate mortgages (also called "ARMs" by the industry), interest-only loans, and no document loans with loan features such as balloon payments, pre-payment penalty, negative amortization, interest only payments,

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[1] Onaran, Yalman, *Banks' Subprime Losses Top $500 Billion on Writedowns*, Bloomberg.com, August 12, 2008; HOPE Now Task Force, *Final Report and Recommendations,* April 18, 2008. The Pew Charitable Trusts, *Defaulting on the Dream: States Respond to America's Foreclosure Crisis*, April 2008; *Troubles Aside, Bear Sterns Tops RMBS*, Asset Securitization Report, April 7, 2008; Texas Department of Banking & Texas Department of Savings & Mortgage Lending, *Condition of the Texas State Banking System: A Report to the Finance Commission of Texas*, March 31, 2008; Center for Responsible Lending, *Study on Subprime Spillover: Foreclosures Cost Neighbors $202 Billion; 40.6 Million Homes Lose $5,000 on Average*, January 18, 2008; Rieker, Matthias, *Cookie Cutter Won't Cut It for Big Five This Quarter: The big questions likely to confront the biggest banks this earnings season*, American Banker, January 10, 2008; *Hearing Before the U.S. House of Representative Financial Serv. Comm.,* 110th Congress (Dec. 2007) (statement of Sheila Bair, Chairman of the Federal Deposit Insurance Corporation); Dallas Business Journal, *Mayors' report focuses on economic impact of foreclosures*, November 28, 2007; *Bad Mortgages drive bank profits down 25%: FDIC provisions at highest level since 1987,* Associated Press, November 29, 2007.

[2] Texas Department of Banking & Texas Department of Savings & Mortgage Lending, *Condition of the Texas State Banking System: A Report to the Finance Commission of Texas* (March 31, 2008).

and teaser rates.[3] In the hottest real estate markets in the country, statistics show that almost 70 percent of new loans are the result of these new loan products.[4] The following illustrates the four general types of loan products available to consumers.

- ***Prime***-Serves borrowers with strong credit histories and provides the most competitive interest rates and mortgage terms.
- ***Alternative-A (Alt-A)***-Generally serves borrowers whose credit histories are close to prime, but loans often have one or more higher-risk features such as limited documentation of income or assets.
- ***Subprime***-Generally serves borrowers with blemished credit and features higher interest rates and fees than the prime market.
- ***Government-insured or -guaranteed***-Primarily serves borrowers who may have difficulty qualifying for prime mortgages but features interest rates competitive with prime loans in return for payment of insurance premiums or guarantee fees. The Federal Housing Administration (FHA) and Department of Veterans Affairs (VA) operate the two main federal programs that insure or guarantee mortgages.

Adjustable rate mortgages account for 40 percent of all mortgage loans in the United States.[5] An adjustable rate mortgage is a mortgage with an interest rate that is linked to an economic index. The interest rate and the homeowner's payments are periodically adjusted up or down as the index changes; if interest rates increase, the mortgage payment also increases.

Interest-only loans occur when the homeowner pays the interest part of the loan first, for a period of 2, 3, 5, 7 or 10 years.[6] After the interest period, the mortgage becomes fully amortized, and the homeowner must pay both interest and principal. Because the homeowner is repaying the principal in 20 or 25 years (not 30 years), those principal payments at year 5, 7, or 10, are higher than they would have been at a traditional fix-rate mortgage. If a homeowner cannot make the higher payments, foreclosure could occur and the homeowner would have no equity in their house.

While prime borrowers with good credit can obtain adjustable rate mortgages and interest-only loans, these new products allow borrowers who cannot qualify for prime loans to access lending

[3] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008).
[4] Lenders also provided additional incentives, including "no-closing costs" advertisement.
[5] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008); *See* Federal Reserve Board, *Study on Home Lending*, July 11, 2006.
[6] *Id.*

for housing through subprime loans.[7] The federal agencies which regulate the financial institutions industry define the term "subprime" as referring to the credit characteristics of individual borrowers.[8]

Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems such as charge-offs, judgments, and bankruptcies. Borrowers may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers.

Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- Bankruptcy in the last 5 years;
- Relatively high default probability as evidenced by a credit bureau risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and/or
- Debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.[9]

Subprime lending grew substantially in recent years. Many mortgage lenders became quite active originators. Prior to the foreclosure crisis of 2007 and 2008, the subprime market served an important role in providing the necessary access to credit for certain potential home buyers. These products gave consumers access to the housing market which was previously unavailable. As illustrated below, the overall percentage of U.S. homeownership dramatically rose, beginning in the mid-1990s from 64-65% to 68-69% in 2005.[10]

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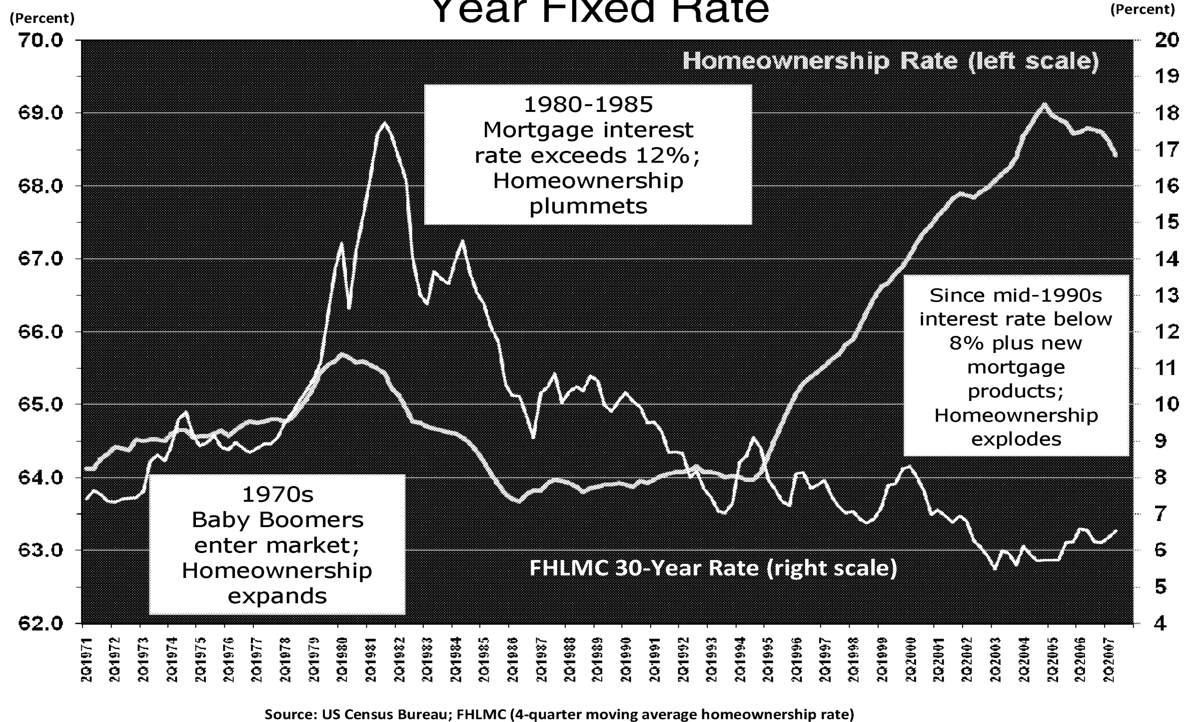
[7] Predatory lending is often inaccurately confused with subprime lending. While there seems to be no definitive definition for predatory lending, the United States General Accounting Office defines the term “predatory lending” to characterize a range of practices, including deception, fraud, or manipulation, that a mortgage broker or lender may use to make a loan with terms that are disadvantageous to the borrower. *See* United States General Accounting Office, *Federal and State Agencies Face Challenges in Combating Predatory Lending* (January 2004).

[8] The Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

[9] Federal Deposit Insurance Corporation, *Subprime Lending* (January 2001).

[10] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Dr. James Gaines, Real Estate Center at Texas A&M University).

US Homeownership Rate and the FHLMC 30-Year Fixed Rate



Credit Card Products

Coupled with the increase of mortgage lending products available to consumers, credit cards are another important tool that affect consumers' ability to borrow and spend money. Due to an imbalance among state laws, credit card companies locate in states with more liberal lending laws where the companies can use the exportation of interest doctrine to charge and assess various fees.[11]

> The exportation doctrine operates under the principle that a bank located in one state is permitted to use the laws of its home state and export interest rates to borrowers located in other states. In other words, a bank located in South Dakota may issue credit cards to borrowers in Texas, or any other state, using the interest rates and fee authority found in South Dakota law, without regard to the provisions of Texas law regulating the same subject. The exportation authority hinges on the definition of interest as found in federal law and regulation…the result of this broad definition and liberal application permit federally-chartered

[11] *Investigation and Correction of Credit Card Billing Errors: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Commissioner Leslie Pettijohn, Texas Office of the Consumer Credit Commissioner).

> financial institutions to export an expansive range of fees and interest rates from one state to the citizens of another state.[12]

According to the Federal Deposit Insurance Corporation, the top ten credit card issuers control approximately 90 percent of the credit card market.[13]

Texas law limits rates to 18 percent and only allows specific fees to be assessed.[14] Because Texas law is more restrictive, very few credit card companies are subject to state law; therefore, any changes by the Texas Legislature would not impact the large credit card companies.

Federal and State Regulatory Agencies

In order to fully appreciate the dual banking system and its effect on financial institutions, the law of preemption must be understood. The preemption doctrine derives from the Supremacy Clause of the Constitution, meaning that any federal law (even rules promulgated by federal agencies) supersedes conflicting state law.[15]

This legal doctrine prohibits any state laws that obstruct, impair, or condition a national financial institution's ability to fully exercise its federally authorized powers. In considering foreclosures, credit card problems and other financial problems that impact Texas, citizens and lawmakers must understand that certain problems cannot be fixed by the Texas Legislature due to preemption. However, the Texas Legislature can regulate state-licensed financial institutions.

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration (known collectively as the federal banking regulators) regulate the depository institutions that perform lending services to consumers. Congress empowered these agencies to regulate financial institutions with the Home Ownership and Equity Protection Act (HOEPA) of 1994, the Fair Housing Act and Equal Credit Opportunity Act.[16] The Federal Trade Commission (FTC) is authorized to prohibit and take action against unfair or deceptive acts as well as practices in or affecting commerce.

In Texas, the Texas Department of Banking regulates state banks. The Texas Department of Savings & Mortgage Lending oversees first lien mortgages, state thrifts and mortgage brokers. The Texas Office of the Consumer Credit Commissioner regulates the secondary mortgage and home equity lending markets and tax lien lenders.

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[12] *Id.*
[13] *Id.* The top ten issuers are Bank of America, JPMorgan Chase, Citigroup, American Express, Capital One, Discover Card, HSBC, Washington Mutual, Wells Fargo and US Bancorp.
[14] *See* TEX. FIN. CODE § 343; *See also* 12 U.S.C § 85 & 12 C.F.R. § 7.4001.
[15] U.S. CONST. art. VI.
[16] HOEPA places restrictions on certain high-cost loans, including limits on prepayment penalties and balloon payments and prohibitions against negative amortization; however, it covers only loans that exceed certain rate or fee triggers and thus only a portion of all subprime loans; *See also* 42 U.S.C. 3601 and 15 U.S.C. 1691.

ANALYSIS

In July 2006, the Federal Reserve Board released a report on Bank Lending Practices.[17] When questioned about the practices of approving residential mortgage loans, about 10 percent of domestic institutions indicated that they had eased credit standards on residential mortgage loans.[18]

The survey asked what percentage of subprime residential mortgages comprised part of the responding banks' holdings. Of the thirty domestic banks with subprime residential mortgages, most indicated that such mortgages accounted for less than 5 percent of their residential mortgages. Six institutions noted that subprime mortgages accounted between 5 percent and 15 percent of their total mortgage section. The remainder of banks reported a share that was more than 20 percent. Those institutions that reported a share between 5 percent and 15 percent account for 22 percent of all such mortgages.[19] Within two years, these subprime loans became the financial domino effect throughout the economy.

Semita Ut Tendo

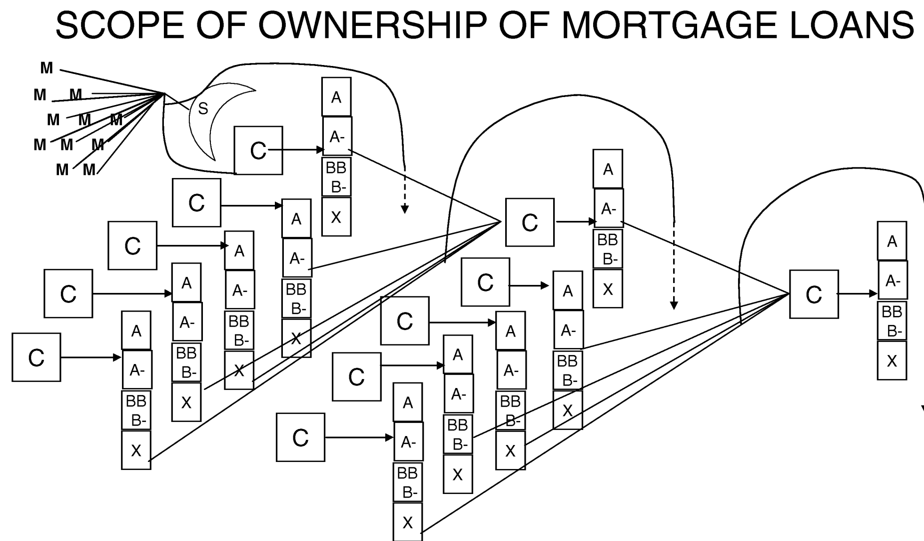
The path to the present situation began with the Gramm-Leach-Bliley Financial Services Modernization Act in 1999. As new products entered the market, the Federal Reserve lowered the interest rates beginning in 2001 through 2004.[20] The lower rates allowed credit to become available to more people, including credit for home loans, credit cards and other lending products. People with lower credit scores entered the housing market through exotic loans and riskier credit practices. Individuals who obtained these loans and the lenders who offered the products assumed that the housing market valuation would continue to rise; thus, any negative consequences would be mitigated.

Most originating mortgage lenders no longer retain mortgage loans in their portfolio, as local thrift institutions traditionally did. Instead, most originating lenders transfer mortgage loans on the secondary market to facilitate the eventual securitization of mortgage loans and the issuance

[17] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, July 2006. The report is based on responses to questions posed to senior loan officers. *See also* Department of Housing and Urban Development, *Curbing Predatory Home Mortgage Lending* (June 2000).
[18] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices* (July 2006), pg.22-35. The subprime category of residential mortgages includes loans made to borrowers that displayed one or more of the following characteristics at the time of loan origination: weakened credit histories stemming from payment delinquencies, charge-offs, judgments, or bankruptcies; reduced repayment capacity as measured by credit scores or debt-to-income ratios; and incomplete credit histories. Non-traditional residential mortgage products include—but are not limited to—adjustable-rate mortgages with multiple payment options, interest-only mortgages, and "Alt-A" products such as mortgages with limited income verification and mortgages secured by non-owner-occupied properties. In considering subprime residential mortgages, banks were instructed to include first-lien loans only.
[19] *Id.*
[20] These products include adjustable rate mortgages, interest-only mortgages and no document loans.

of mortgage-backed securities. When the originating lender sells a mortgage loan, it will typically transfer the loan documents to the new assignee or to a loan servicer (the party who collects loan payments from mortgagors on behalf of the party holding the mortgage debt).

These loan products were bundled, repackaged and sold off to investors, then repackaged again and sold off to investors, and the credit agencies did not deem them to be high-risk. The diagram below illustrates the securitization of mortgage products.[21]



While the selling and investing of mortgage-backed securities permeated the market, the real estate bubble burst in the high-valued markets such as the West Coast.[22] Historically, subprime loans and loans to low-moderate income borrowers generally have foreclosure rates over 10 times the rate of prime loans. Homeowners began defaulting on their loans, which caused the values of investments based on these mortgages to decline. The true value of these mortgages, and thus the investments, was difficult to determine due to an inability to assume proper real estate values.

As a result of the decline in real estate, securities and other investments, financial institutions suffered collateral and liquidity issues, which caused an overall national credit crunch. This credit crunch affects every consumer, making it more difficult to borrow or obtain a loan. When consumers have restricted access to credit, they spend less which negatively impacts the overall economy.

[21] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008). The diagram was provided by Bill Stutts.
[22] *Id.*

Many people fear America is potentially facing another Great Depression with the collapse of the housing markets, credit crunch and resulting federal intervention. However, consider the following statement comparing the current crisis to the Great Depression:[23]

> Still, to liken our situation to the Great Depression…people lost their homes even though they had borrowed only 10 percent of the purchase price. People losing their homes today frequently have borrowed 90 percent or more. The country approached double-digit unemployment in the early 1980s.[24]

While experts can debate whether or not America is in a recession, it is important to note how the financial markets affect individual lives. This year has seen the failure and collapse of the mortgage financial market including, but not limited to, companies such as Bear Stearns, Indy Mac, Freddie Mac, Fannie Mae, Merrill Lynch, Lehman Brothers, AIG, Washington Mutual, and Wachovia.[25]

The U.S. subprime crisis and tightening of credit resulted in over $500 billion as "the write-downs spread to more asset types". [26] Some experts warn that the losses could exceed $2 trillion.[27] The following chart indicates the top 15 companies with asset write-downs and credit losses as well as the capital raised in response; all numbers are in **billions** of U.S. dollars.

Top 15 Companies[28]

Firm	Write-down & Loss	Capital Raised
Citigroup	$60.7	$49.1
Merrill Lynch	$51.8	$29.9
UBS	$44.2	$28.3
HSBC	$27.4	$3.9
Wachovia	$22.5	$11
Bank of America	$27.3	$20.7
JPMorgan Chase	$18.2	$7.9
Morgan Stanley	$15.7	$5.6
IKB Deutsche	$15.3	$12.6
Royal Bank of Scotland	$14.9	$24.3
Washington Mutual	$14.8	$12.1
Deutsche Bank	$10.8	$3.2
Credit Suisse	$10.5	$2.7
Wells Fargo	$10	$4.1
Barclays	$9.1	$18.6

[23] Amity Shlaes, *What Phil Gramm got right,* Washington Post, Tuesday, July 15, 2008. Reprinted and available at: http://www.statesman.com/opinion/content/editorial/stories/07/14/0715shlaes_edit.html. Amity Shlaes is a senior fellow in economic history at the Council on Foreign Relations.

[24] *Id*.

[25] As of October 1, 2008, the United States has seen the collapse or failure of 121 lending institutions as a result of the subprime mortgage issues.

[26] Onaran, Yalman, *Banks' Subprime Losses Top $500 Billion on Writedowns*, Bloomberg.com, August 12, 2008. Available at: http://www.bloomberg.com/apps/news?pid=20601087&sid=aSKLfqh2qd9o&refer=worldwide.
The International Monetary Fund in an April report estimated banks' losses at $510 billion, about half its forecast of $1 trillion for all companies.

[27] *Id*. *See also* Saporito, Bill. *The Big Bank Bailout: Are You Next?*, Time Magazine, October 16, 2008. Available at: http://www.time.com/time/magazine/article/0,9171,1851140,00.html.

[28] *Id*.

At the time of publication, several of the financial institutions listed above were purchased or merged with other financial institutions.

However, financial institutions are not the only entities suffering. The largest cities in the United States are expected to lose over $45 billion in tax revenues: New York with $10 billion, Los Angeles with $8.3 billion, Dallas-Ft.Worth with $4 billion, Washington with $4 billion and Chicago with $3.9 billion.[29]

Congressional and Federal Action

Since August 2007, Congress and the federal agencies are taking unprecedented steps to stabilize credit markets and the broader economy.[30] The early warning signs became red flags.

On March 13, 2007, New Century Financial Corporation released a statement that the US. Securities and Exchange Commission was investigating the lenders on its accounting practices. After months of investigations, the Federal Trade Commission announced a settlement in which JPMorgan Chase agreed to pay consumers $28 million and change their procedures to settle charges of engaging in unlawful mortgage servicing practices.[31]

In August 2008, Congress passed and the President signed the omnibus Housing and Economic Recovery Act of 2008.[32] The Act contains the following provisions:

- The HOPE for Homeowners Act: Creates an initiative within the Federal Housing Administration (FHA) to prevent foreclosures for hundreds of thousands of families at no estimated cost to American taxpayers.
- Assistance for Communities Devastated by Foreclosures**:** To ensure that communities can mitigate the harmful effects of foreclosures, $3.92 billion in supplemental Community Development Block Grant Funds will be provided to communities hardest hit by foreclosures and delinquencies.
- Foreclosure Counseling for Families in Need: To help families avoid foreclosure, the bill provides $180 million in additional funding for housing counseling and legal services for distressed borrowers.
- GSE Reform: Creates a regulator for the government-sponsored enterprises (GSEs) so that these vital institutions can safely and soundly carry out their important mission of providing our nation's families with affordable housing.

[29] Dallas Business Journal, *Mayors' report focuses on economic impact of foreclosures*, November 28, 2007.
[30] *See* American Banker, *A Crisis Timeline*, September 25, 2008, Available at: http://www.americanbanker.com/media/pdfs/091808FedTimeline.pdf
[31] JPMorgan Chase bought Bear Stearns in May 2008. The charges were against Bear Stearns Cos. and its EMC Mortgage Corp., which occurred before JPMorgan Chase bought Bear Stearns.

[32] Housing and Economic Recovery Act of 2008, H.R. 3221, 110th Congress (2008). Available at: http://thomas.loc.gov/cgi-bin/bdquery/z?d110:h.r.03221; *See also* United States Senate Comm. on Banking, Housing and Urban Affairs. Available at: http://banking.senate.gov/public/_files/HousingandEconomicRecoveryActSummary.pdf.

- Treasury Emergency Authority: To shore up confidence of the financial markets in Fannie Mae, Freddie Mac and the Federal Home Loan Banks, the legislation contains several temporary provisions requested by the Treasury Secretary including authority for the Treasury Dept. to purchase common stock and debt securities issued by the GSEs.
- Preserving the American Dream for Our Nation's Veterans: This bill contains several provisions to help returning soldiers avoid foreclosure, including lengthening the time a lender must wait before starting foreclosure from three months to nine months after a soldier returns from service.
- FHA Modernization: Reforms to modernize, streamline and expand the reach of the FHA, allowing families in all areas of the country to access secure and affordable mortgages through FHA.
- Affordable Housing Fund: A new, permanent fund that will help create more affordable housing for Americans in communities across the country.
- Enhancing Mortgage Disclosure: To ensure that consumers know the exact amounts of their mortgage payments, including the maximum possible payment under the terms of the loan and changes in payments associated with adjustable rate mortgages, lenders will be required to provide borrowers with more timely and meaningful mortgage disclosures on all home purchase loans, loans that refinance a home, and loans that provide a home equity line of credit.
- Standard Property Tax Deduction: To make tax relief available to all American homeowners, the bill will provide a standard deduction – $500 for single filers and $1,000 for joint filers – for the 28.3 million non-itemizers who pay property taxes. Present law allows only those who itemize deductions on their federal tax returns to deduct state and local property taxes from their income.
- Mortgage Revenue Bonds: To provide for refinancing of subprime loans, mortgages for first-time homebuyers and multifamily rental housing, this bill includes $11 billion of Federal tax-exempt private activity bond authority.
- Credit for First-Time Homebuyers: The bill includes a refundable tax credit that is equivalent to an interest-free loan equal to 10 percent of the purchase of the home (up to $8,000) by first-time homebuyers to help reduce the existing stock of unoccupied housing.
- Increase in low-income housing tax credit: The Low-Income Housing Tax Credit program helps finance the development of rental housing for low-income families. Under current law, there is a state-by-state limit on the annual amount of federal low-income housing tax credits that may be allocated by each state.[33]

The most important section that the Texas Legislature will have to address is the "Secure and Fair Enforcement of Mortgage Licensing Act of 2008".[34] This Act establishes and requires a system for licensing and registration of all mortgage loan originators in the United States and requires minimum standards for licensing and registration as a state-licensed loan originator.[35]

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[33] *Id.*
[34] *Id.*
[35] The federal legislation contemplates that states will adopt legislation licensing mortgage loan originators within the next two years. If a state does not adopt legislation meeting the minimum requirements for licensing of

Fortunately, the Texas Mortgage Brokers License Act meets the minimum requirements of the new federal legislation for mortgage brokers, but some modifications will be required to comply with the federal legislation.

In July 2008, the Federal Reserve Board approved a final rule for home mortgage loans in Regulation Z, which prohibits unfair, abusive or deceptive home mortgage lending practices and restricts certain other mortgage practices.[36] The rule for these higher-priced loans includes:

- Prohibits a lender from making a loan without regard to borrowers' ability to repay the loan from income and assets other than the home's value. A lender complies, in part, by assessing repayment ability based on the highest scheduled payment in the first seven years of the loan. To show that a lender violated this prohibition, a borrower does not need to demonstrate that it is part of a "pattern or practice." Prohibits a lender from relying on income or assets that it does not verify to determine repayment ability. Bans any prepayment penalty if the payment can change during the initial four years. For other higher-priced loans, a prepayment penalty period cannot last for more than two years. Requires that the lender establish an escrow account for the payment of property taxes and homeowners' insurance for first-lien loans. The lender may offer the borrower the opportunity to cancel the escrow account after one year.

The rule, for all closed-end mortgages secured by a consumer's principal dwelling:

- Prohibits certain servicing practices: failing to credit a payment to a consumer's account as of the date the payment is received, failing to provide a payoff statement within a reasonable period of time, and "pyramiding" late fees. Prohibits a creditor or broker from coercing or encouraging an appraiser to misrepresent the value of a home. Creditors must provide a good faith estimate of the loan costs, including a schedule of payments, within three days after a consumer applies for any mortgage loan secured by a consumer's principal dwelling, such as a home improvement loan or a loan to refinance an existing loan.

The rule, for all mortgages:

- Requires advertising to contain additional information about rates, monthly payments, and other loan features. The rule also bans seven deceptive or

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mortgage loan originators, the Secretary of HUD must set up a system for the licensing and registration of the loan originators operating in such state.

[36] Federal Reserve Board, *Board Issues Final Rule Amending Home Mortgage Provisions of Regulations Z (Truth in Lending)* (July 14, 2008). Available at: http://www.federalreserve.gov/newsevents/press/bcreg/regz20080714.htm. The rule's definition of "higher-priced mortgage loans" will capture virtually all loans in the subprime market, but generally exclude loans in the prime market. To provide an index, the Federal Reserve Board will publish the "average prime offer rate," based on a survey currently published by Freddie Mac. A loan is higher-priced if it is a first-lien mortgage and has an annual percentage rate that is 1.5 percentage points or more above this index, or 3.5 percentage points if it is a subordinate-lien mortgage. This definition overcomes certain technical problems with the original proposal, but the expected market coverage is similar.

misleading advertising practices, including representing that a rate or payment is "fixed" when it can change.[37]

Compliance with the new rules, other than the escrow requirement, is mandatory for all applications received on or after October 1, 2009. The escrow requirement has an effective date of April 1, 2010 for site-built homes, and October 1, 2010 for manufactured homes.

However, by the end of summer, the effects of the subprime lending issues spilled into the lending and credit markets. On September 21, 2008, the last two independent investment banks (Goldman Sachs and Morgan Stanley) converted to bank holding companies.

In September 2008, the federal government placed mortgage giants Fannie Mae and Freddie Mac into a government-run conservatorship. The Treasury Department concluded that Freddie Mac's accounting methods had overstated its capital cushion and were concerned that future defaults among the mortgages held or guaranteed by both companies, which own or back $5.3 trillion in mortgages, could occur. On September 24, 2008, the FBI announced its investigation of potential fraud by mortgage finance giants Fannie Mae and Freddie Mac, insurer American International Group and investment bank Lehman Brothers.

The most drastic steps Congress took to address the economic problems, which originated in the subprime lending arena, was the passage of Emergency Economic Stabilization Act of 2008, H.R. 1424 in October 2008.[38] H.R. 1424 provides authority for the Federal Government to purchase and insure certain types of troubled assets for the purposes of providing stability to and preventing disruption in the economy. The Act contains the following key provisions:

- Provides authority to the Treasury Secretary to restore liquidity and stability to the U.S. financial system and to ensure the economic well-being of Americans.
- Troubled Assets Relief Program. Authorizes the Secretary to establish a Troubled Asset Relief Program ("TARP") to purchase troubled assets from financial institutions. Establishes an Office of Financial Stability within the Treasury Department to implement the TARP in consultation with the Board of Governors of the Federal Reserve System, the FDIC, the Comptroller of the Currency, the Director of the Office of Thrift Supervision and the Secretary of Housing and Urban Development. Requires the Treasury Secretary to establish guidelines and policies to carry out the purposes of this Act. Includes provisions to prevent unjust enrichment by participants of the program.

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[37] Federal Reserve Board, *Board Issues Final Rule Amending Home Mortgage Provisions of Regulations Z (Truth in Lending)* (July 14, 2008).
[38] Emergency Economic Stabilization Act of 2008, H.R. 1424, 110th Congress (2008). Available at: http://thomas.loc.gov/cgi-bin/query/D?c110:6:./temp/~c110fD4kn6.
The bill pass in the Senate by a vote of 74 YEAS, 25 NAYS and 1 NOT VOTING and in the House of Representatives by a vote of 263 YEAS and 171 NAYS. H.R. 1424, the Emergency Economic Stabilization Act of 2008, Energy Improvement and Extension Act of 2008, and Tax Extenders and Alternative Minimum Tax Relief Act of 2008, which authorizes the Secretary of the Treasury to establish a Troubled Assets Relief Program to purchase troubled assets from financial institutions; provides Alternative Minimum Tax relief; extends expiring tax provisions and establishes energy tax incentives; and temporarily increases Federal Deposit Insurance limits.

- Insurance of Troubled Assets. If the Secretary establishes the TARP program, the Secretary is required to establish a program to guarantee troubled assets of financial institutions. The Secretary is required to establish risk-based premiums for such guarantees sufficient to cover anticipated claims. The Secretary must report to Congress on the establishment of the guarantee program.
- Considerations**.** In using authority under this Act, the Treasury Secretary is required to take a number of considerations into account, including the interests of taxpayers, minimizing the impact on the national debt, providing stability to the financial markets, preserving homeownership, the needs of all financial institutions regardless of size or other characteristics, and the needs of local communities. It requires the Secretary to examine the long-term viability of an institution in determining whether to directly purchase assets under the TARP.
- Financial Stability Oversight Board. This section establishes the Financial Stability Oversight Board to review and make recommendations regarding the exercise of authority under this Act. In addition, the Board must ensure that the policies implemented by the Secretary protect taxpayers, are in the economic interests of the United States, and are in accordance with this Act. The Board is comprised of the Chairman of the Board of Governors of the Federal Reserve System, the Secretary of the Treasury, the Director of the Federal Home Finance Agency, the Chairman of the Securities and Exchange Commission and the Secretary of the Department of Housing and Urban Development. Monthly Reports: Within 60 days of the first exercise of authority under this Act and every month thereafter, the Secretary is required to report to Congress its activities under TARP, including detailed financial statements. Tranche Reports: For every $50 billion in assets purchased, the Secretary is required to report to Congress a detailed description of all transactions, a description of the pricing mechanisms used, and justifications for the financial terms of such transactions.
- Regulatory Modernization Report. Prior to April 30, 2009, the Secretary is required to submit a report to Congress on the current state of the financial markets, the effectiveness of the financial regulatory system, and to provide any recommendations.
- Management & Sale of Troubled Assets. Establishes the right of the Secretary to exercise authorities under this Act at any time. It provides the Secretary with the authority to manage troubled assets, including the ability to determine the terms and conditions associated with the disposition of troubled assets. The Act requires profits from the sale of troubled assets to be used to pay down the national debt. It allows the Secretary to waive provisions of the Federal Acquisition Regulation where compelling circumstances make compliance contrary to the public interest. Such waivers must be reported to Congress within 7 days. If provisions related to minority contracting are waived, the Secretary must develop alternate procedures to ensure the inclusion of minority contractors. Allows the FDIC to be selected as an asset manager for residential mortgage loans and mortgage-backed securities.
- Foreclosure Mitigation Efforts**.** For mortgages and mortgage-backed securities acquired through TARP, the Secretary must implement a plan to mitigate foreclosures and to encourage servicers of mortgages to modify loans through Hope for Homeowners and other programs. The Act allows the Secretary to use loan guarantees and credit enhancement to avoid foreclosures. Requires the Secretary to coordinate with other

federal entities that hold troubled assets in order to identify opportunities to modify loans, considering net present value to the taxpayer.

- Assistance to Homeowners. Requires federal entities that hold mortgages and mortgage-backed securities, including the Federal Housing Finance Agency, the FDIC, and the Federal Reserve to develop plans to minimize foreclosures. Requires federal entities to work with servicers to encourage loan modifications, considering net present value to the taxpayer.
- Executive Compensation and Corporate Governance. Provides that Treasury will promulgate executive compensation rules governing financial institutions that sell it troubled assets. Where Treasury buys assets directly, the institution must observe standards limiting incentives, prohibiting golden parachutes. When Treasury buys assets at auction, an institution that has sold more than $300 million in assets is subject to additional taxes, including a 20% excise tax on golden parachute payments triggered by events other than retirement, and tax deduction limits for compensation limits above $500,000.
- Graduated Authorization to Purchase. Authorizes the full $700 billion as requested by the Treasury Secretary for implementation of TARP. Allows the Secretary to immediately use up to $250 billion in authority under this Act. Upon a Presidential certification of need, the Secretary may access an additional $100 billion. The final $350 billion may be accessed if the President transmits a written report to Congress requesting such authority. The Secretary may use this additional authority unless within 15 days Congress passes a joint resolution of disapproval which may be considered on an expedited basis.
- Termination of Authority**.** Provides that the authorities to purchase and guarantee assets terminate on December 31, 2009. The Secretary may extend the authority for an additional year upon certification of need to Congress.
- Increase in the Statutory Limit on the Public Debt**.** Raises the debt ceiling from $10 trillion to $11.3 trillion.
- Hope for Homeowners Amendments. Strengthens the Hope for Homeowners program to increase eligibility and improve the tools available to prevent foreclosures.
- Congressional Oversight Panel. Establishes a Congressional Oversight Panel to review the state of the financial markets, the regulatory system, and the use of authority under TARP. The panel is required to report to Congress every 30 days and to submit a special report on regulatory reform prior to January 20, 2009. The panel will consist of 5 outside experts appointed by the House and Senate Minority and Majority leadership.
- Disclosures on Exercise of Loan Authority. Requires the Federal Reserve to provide a detailed report to Congress, in an expedited manner, upon the use of its emergency lending authority under Section 13(3) of the Federal Reserve Act.
- Exchange Stabilization Fund Reimbursement. Protects the Exchange Stabilization Fund from incurring any losses due to the temporary money market mutual fund guarantee by requiring the program created in this Act to reimburse the Fund. Prohibits any future use of the Fund for any guarantee program for the money market mutual fund industry.
- Study on Mark-to-Market Accounting. Requires the SEC, in consultation with the Federal Reserve and the Treasury, to conduct a study on mark-to-market accounting standards as provided in FAS 157, including its effects on balance sheets, impact on the quality of financial information, and to report to Congress within 90 days on its findings.

- Recoupment. Requires that in 5 years, the President submit to the Congress a proposal that recoups from the financial industry any projected losses to the taxpayer.
- Gain or Loss From Sale or Exchange of Certain Preferred Stock. Details certain changes in the tax treatment of losses on the preferred stock of certain GSEs for financial institutions.
- Special Rules for Tax Treatment of Executive Compensation of Employers Participating in the Troubled Assets Relief Program. This applies limits on executive compensation and golden parachutes for certain executives of employers who participate in the auction program.
- Extension of Exclusion of Income From Discharge of Qualified Principal Residence Indebtedness. This extends current law tax forgiveness on the cancellation of mortgage debt.[39]

This legislation will take several months to fully comprehend its impact. While the Texas Legislature convenes in January 2009, the nation will have a better understanding of how this legislation will affect the economy.

Committee Hearings

On January 23, 2008 and June 11, 2008, the Committee held hearings on lending issues including the mortgage foreclosure process, disclosures for loan terms, home equity, mortgage brokers, mortgage bankers, consumer protections, and counseling for mortgage products.
Several stakeholders testified at the hearing, including homeowners and representatives from the lending community.[40]

The lending stakeholders testified that the industry is dealing with the surge in defaults, particularly among borrowers with subprime loans and adjustable rate mortgages that initially had attractive "teaser" interest rates but then adjusted upward, resulting in a payment shock. Many of the loans, some of which adjust in as little as two years, were issued in 2005 and 2006 during the height of the housing boom.[41]

Every state is affected by the subprime mortgage foreclosures. Nearly every state had a 20 percent increase in foreclosures from December 2006 to December 2007 and ten states will lose

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[39] *Id.*
[40] Stakeholder who testified at the hearings or submitted written testimony include Alan Bush (Federal Deposit Insurance Corporation), Doug Foster (Texas Department of Savings & Mortgage Lending), Joe Collins (Independent Bankers Association of Texas), Bob Bacon (Texas Department of Banking), Robert Doggett (Texas Low Income Housing Information Service), JoAnn DePenning (Texas Foreclosure Prevention Task Force), Dr. James Gaines (Texas Real Estate Center), Connie Hearn (Dallas/Ft.Worth Association of Mortgage Brokers), Everett Ives (Texas Association of Mortgage Brokers), Roland Love (Texas Land Title Association), Gary Maler (Texas Real Estate Center), Todd Mark (Consumer Credit Counseling Service of Greater Dallas), Karen Neeley (Independent Bankers Association of Texas), Robert Power (Countrywide Financial Corporation), Pablo Schneider (Hispanic Alliance For Progress Institute), Norma Minnis (Dallas/Ft.Worth Association of Mortgage Brokers), William Stutts, Connie Rowe, Patricia Logsdon, and Ron Williams (Texas Association of Local Housing Agencies).
[41] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008).

over $6.6 billion in tax revenue in 2008 as a result of the foreclosure crisis.[42] While the recent Congressional legislation will help the problems, many states are enacting legislation to combat the impact of foreclosures. Such legislation includes criminalizing mortgage fraud, increasing mortgage licensing requirements, increase funding for the state banking agencies, revise foreclosure laws, prevent foreclosure rescue scams, increase consumer awareness and create foreclosure intervention products.[43]

When considering the issues Texas faces, the Committee asked for testimony on the national problems and other state specific problems. The mortgage lending stakeholders provided data and studies to assist the Committee in understanding the issues. The following information depicts how foreclosures in a few states are driving the overall mortgage foreclosure problems.

> The problems in California and Florida are extraordinary and they are the main drivers of the national trend. The quarterly rate of foreclosure starts on subprime ARM loans in California was 9.24 percent. This rate, combined with Florida's rate of 8.25 percent, drove up the national average foreclosure start rate to the point where 43 states were below the national average of 6.32 percent. California saw a total of approximately 109,000 foreclosure starts and Florida 77,000. The next highest states were Texas, Michigan and Ohio with between 24,000 and 20,000 each.
>
> California, Florida, Arizona and Nevada combined represent:
> - 62 percent of all foreclosures started on prime ARM loans, and 84 percent of the increase in prime ARM foreclosures
> - 49 percent of all of the subprime ARM foreclosures started in the country during the 1st quarter, and were responsible for 93 percent of the increase in subprime ARM foreclosures
> - 29 percent of prime fixed-rate foreclosures and 60 percent of the increase in those foreclosures
> - 25 percent of subprime fixed-rate foreclosures and 53 percent of the increase in those foreclosures[44]

The following table compares each product type's share of the loans outstanding in the US to each product's share of foreclosure starts.[45]

[42] The Pew Charitable Trusts, *Defaulting on the Dream: States Respond to America's Foreclosure Crisis* (April 2008). The ten states are California, Florida, Michigan, Ohio, Texas, New York, Georgia, Illinois, Indiana and Pennsylvania. Only Alaska, Montana and Vermont did not experience a 20% increase.
[43] *Id*. Colorado, Massachusetts, Maine, Minnesota, New York, North Carolina, Ohio, Rhode Island, South Carolina enacted similar legislation.
[44] Mortgage Bankers Association, *M2008 1st Quarter MBA's National Delinquency Survey*, June 5, 2008. The National Delinquency Survey collects data from more than 44 million mortgage loans serviced by mortgage companies, commercial banks, thrifts, credit unions and others.
[45] *Id*.

PRODUCT	% of US LOANS OUTSTANDING	% of US FORECLOSURES STARTED
Prime Fixed	65%	19%
Prime ARM	15%	23%
Subprime Fixed	6%	11%
Subprime ARM	6%	39%
FHA	8%	7%
TOTAL	100%	100%

This chart depicts the current national residential statistics and their loan type.

CURRENT RESIDENTIAL STATISTICS[46]

- About 65% of US owner-occupied homes have a mortgage (64% in Texas) – 76% are fixed-rate
- About 7.5 million, 13%-14% of all mortgages are subprime
- 75 percent of all Subprime loans originated since 2003
- About two-thirds of Subprime loans in ‘05 and ‘06 were ARMs
- Roughly 7% of homeowners have negative equity
- Falling home prices in key areas eliminates refinancing or selling when a borrower gets behind

The main concern for the Committee is how Texas's real estate market is performing and whether Texas will face the same problems as California, Florida or Nevada. In October 2005, Texas ranked sixth in the nation in mortgage foreclosure filings.[47] In January 2008, Texas ranked fifth in the nation with 26,773 foreclosure filings, up 7.6 percent from 2006.[48] However, by June 2008, foreclosure filings in Texas were down to 4.6 percent.[49] Foreclosure filings include default notices, auction sale notices and bank repossessions.[50]

[46] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Dr. James Gaines, Texas Real Estate Center at Texas A&M University).
[47] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008).
[48] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Dr. James Gaines, Texas Real Estate Center at Texas A&M University); *See* Realty Trac, Available at: www.realtytrac.com. RealtyTrac provides information on foreclosure filings; *See also* Veiga, Alex. *U.S. Home Foreclosures Soar*, Austin American-Statesman, Sept. 18, 2007.
[49] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Dr. James Gaines, Texas Real Estate Center at Texas A&M University); *See* Realty Trac, Available at: www.realtytrac.com.
[50] Foreclosure filings do not equal final foreclosures. Some properties might have received more than one notice if the owners have multiple mortgages.

While Texas foreclosure filings (which do not necessarily indicate final foreclosure) have increased and then decreased in the last two years, the filings have increased by less than 10 percent. For comparison, California's filings increased by 238 percent, Nevada increased by 215 percent, Virginia increased by 456 percent and Connecticut increased by 100 percent.[51] Most states' foreclosure filings increased by over 100 percent in the last year.[52]

The following three diagrams illustrate the current market conditions in Texas and the foreclosure filings in Texas compared to the national average.[53]

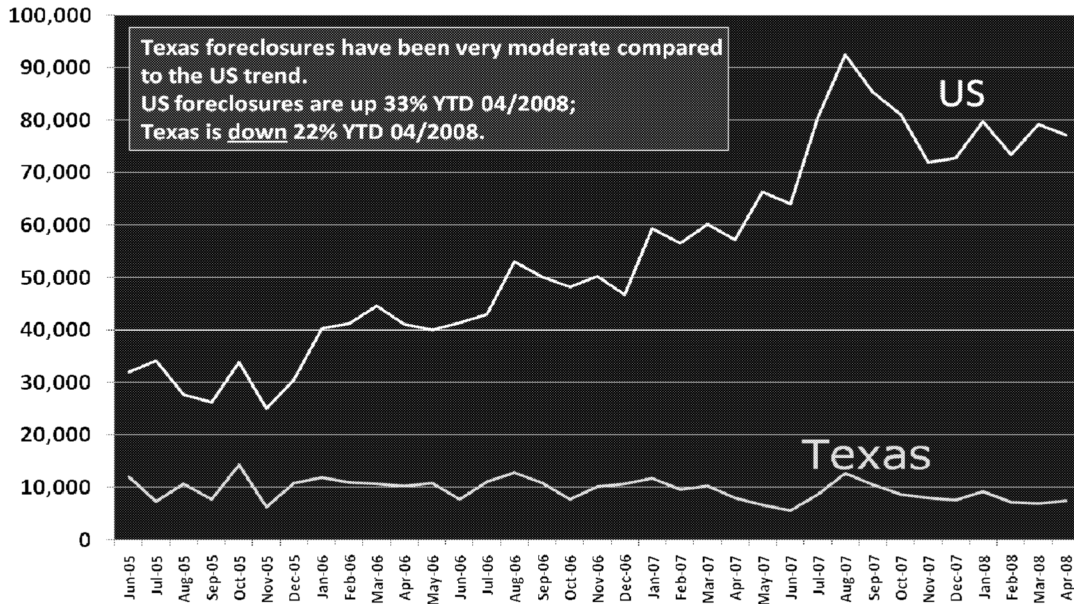
Mortgage Status of Owner-Occupied Homes in Texas

	Number of Owner-Occupied Homes	Percent of Total Units with Mortgage	Percent of Total O-O Units
Total	5,291,045		
Housing units with a mortgage, contract to purchase, or similar debt:	3,368,890		63.7%
First Mortgage only: No second mortgage and no home equity loan	2,987,396	88.7%	
With either a second mortgage or home equity loan, but not both:	369,986	11.0%	
Second mortgage only	173,269	5.1%	
Home equity loan only	196,717	5.8%	
With both a second mortgage and home equity loan	11,508	0.3%	
Housing units without a mortgage	1,922,155		36.3%

Source: U.S. Census Bureau, 2006 American Community Survey

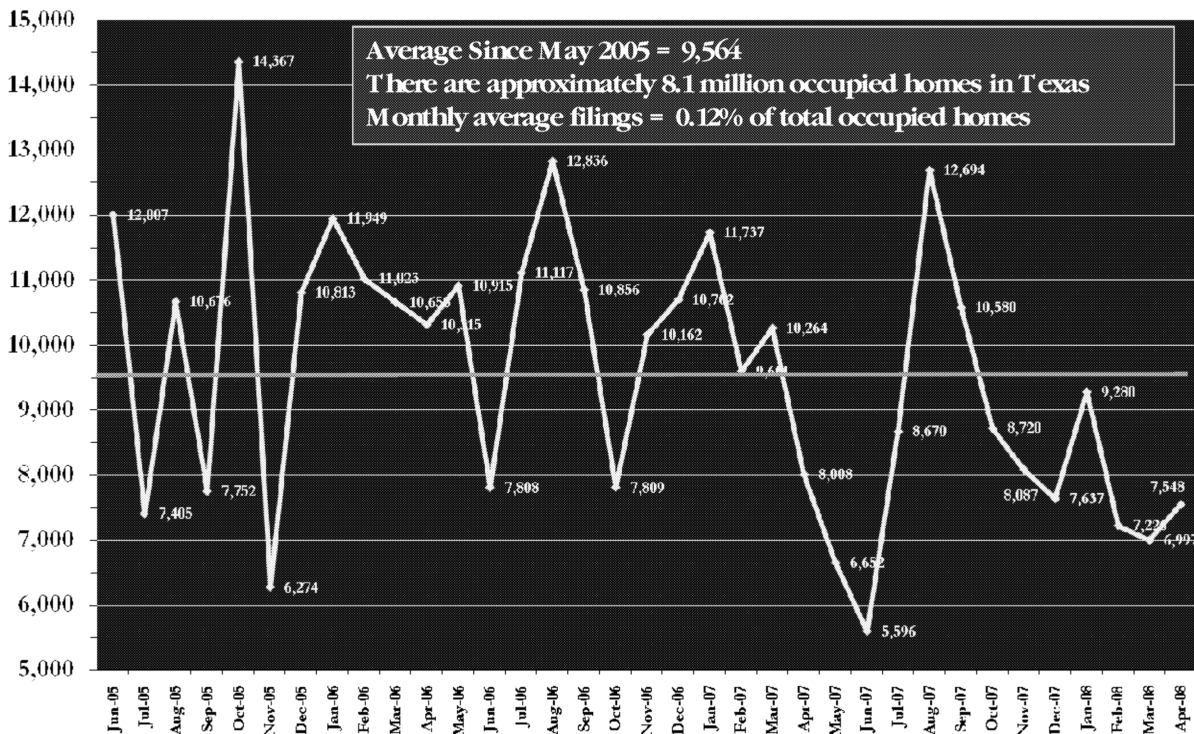
[51] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Dr. James Gaines, Texas Real Estate Center at Texas A&M University); *See* Realty Trac, Available at: www.realtytrac.com.
[52] *Id*.
[53] *Id*.

Monthly Foreclosure Filings



Source: RealtyTrac, Inc.
Data include Notices of Trustee Sales plus Notices of Foreclosure Sale as of April 2008

Monthly Texas Foreclosure Filings



Source: RealtyTrac, Inc., American Community Survey, US Census
Data include Notices of Trustee Sales plus Notices of Foreclosure Sale

The Committee discussed the role of the various players in the mortgage lending process and questioned whether fiduciary relationships exist and whether the borrower understands the loan process and terms in the contract. The following list identifies the main players in the transaction:[54]

- Borrower
- Borrower's Real Estate Agent
- Seller & Broker Owner
- Seller's Real Estate Agent
- Mortgage Broker
- Loan Officer
- Loan Processor
- Loan Underwriter
- Lender
- Title Agent Representative
- Fee Attorney
- Appraisers
- Bank Employee – deposit verifications
- Employer – employment verifications
- Third party service provider

Several stakeholders testified that easy credit fueled the housing market and that in over half of the market, the "median mortgage payment exceeded the traditional lending guideline of 28 percent of household income."[55] Most of the homeowners borrowed more than they could afford and did not fully understand the ramifications of maximizing the credit available to purchase their homes. [56]

The Committee asked whether the foreclosures in Texas were higher in certain ethnic regions, including the border.[57] Stakeholders testified that certain areas, such as McAllen-Edinburg, Brownsville-Harlingen and Laredo, have a higher percentage of subprime loans and foreclosure filings.[58] However, one reason for the disparity is that many Hispanic home buyers lack good credit. Hispanic homeowners may have cash income, but no bank account, credit cards or auto loans — factors that penalize them in the traditional mortgage-lending environment.[59]

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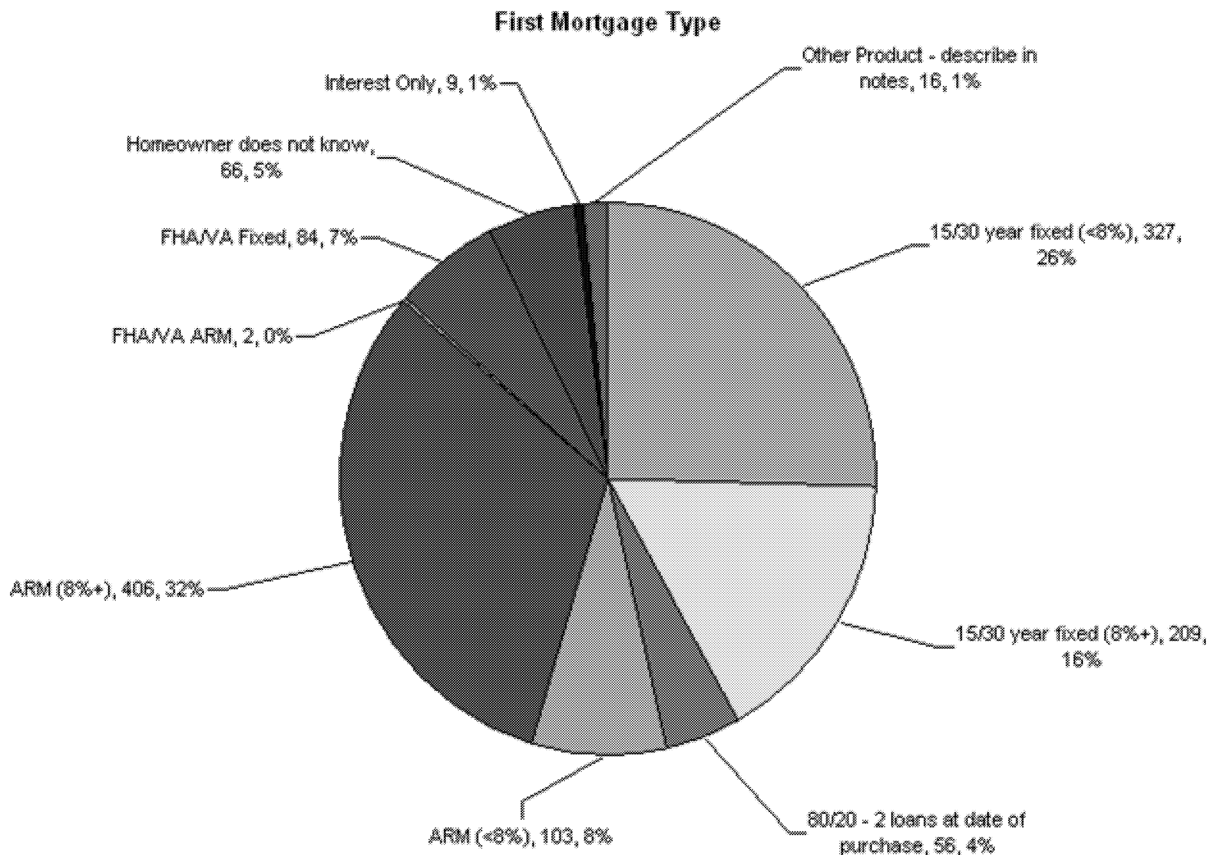
[54] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Commissioner Doug Foster, Texas Department of Savings & Mortgage Lending).
[55] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008); *See also* Mertz Esswein, Patricia*, The Worst Is Yet To Come*, Kiplinger's Personal Finance, January 2008.
[56] *Id*.
[57] A September 2007 report by the National Association of Hispanic Real Estate Professionals found that Hispanic homeowners are twice as likely to have subprime mortgage loans as Anglo homeowners of similar means.
[58] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Dr. James Gaines, Texas Real Estate Center at Texas A&M Center); *See* Realty Trac, Available at: www.realtytrac.com.
[59] *Id*.

Due to these problems, several experts testified that lenders and consumer advocacy groups are working together to help homeowners. For example, HOPE NOW Alliance is a federally initiated group of 11 lenders which service subprime loans.[60] The Texas Foreclosure Prevention Task Force is specifically working with consumers facing foreclosure.[61] The goal of this task force is the following:

- Raising awareness about the nationally endorsed 888-995-HOPE Hotline
- Supporting local foreclosure prevention and intervention initiatives
- Encouraging the creation of new initiatives in areas with high mortgage default rates
- Monitoring mortgage default patterns and trends in Texas through ongoing research to advance timely intervention
- Fundraising to sustain and increase the capacity of local counseling organizations
- Identifying and sharing information about available mortgage assistance programs, including rescue and refinance products
- Analyzing potential legislative recommendations that support homeownership retention and strengthen Texas communities
- Developing a tracking system to measure the effectiveness of these and other task force interventions.[62]

The Texas Foreclosure Prevention Task Force receives approximately 3,000 telephone calls per month. The following chart illustrates the types of mortgages owned by consumers who call the hotline.[63]

[60] The goal of HOPE NOW is to modify loans by freezing the interest rates at the current level.
[61] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of JoAnn DePenning, Texas Foreclosure Prevention Task Force).
[62] *Id.*
[63] *Id*.



Another consideration for the Committee is the stability in the Texas market and the concerns of the Texas financial institution agencies. The Department of Banking testified that the state-banking system is relatively strong.

> Overall, state-chartered banks are operating within acceptable risk profiles and reflect sufficient management, capital, profitability, liquidity and loan loss reserves. Overall, the involvement of state-chartered Texas banks in residential mortgage lending has been measured, prudent, and conducted in a safe and sound manner. However, stresses in the housing markets, including interim construction and land development, have affected some institutions, with a few banks experiencing a marked increase in asset quality issues.
>
> Texas has 328 state-chartered institutions with $152.8 billion in assets, employ 35,335 persons, and operate 1,463 in-state branches and 392 out-of-state branches in eight states (AZ, CA, CO, FL, MI, NM, OK, VA). New Texas state-chartered banks opening in 2007 totaled 14. Capital adequacy is strong with a core position of 9.1%. Loan loss reserves are adequate at 1.11% of total loans. Profitability is acceptable with a return on assets of 1.01% and a return on equity of 9.99%. Loan volume is satisfactory with net loans and leases to total assets at 67.68%. Past due loans are manageable at 1.0% of total loans and leases.

> The primary funding source remains core deposits at 61.26% of total liabilities.
>
> Material residential mortgage loan problems have been avoided due to: minimal credit concentrations; generally sound underwriting; and statutory limitation on home equity loans at 80% of the property's appraised value. 1-4 family mortgage loans total $11.5 billion or 7.46% of gross bank assets, a decrease from 9.45% and 10.11% as of March 2005 and 2002, respectively. *(Nationwide, 1-4 family mortgages at commercial banks are 17.19% of gross bank assets.)* Past due residential mortgages are manageable at 1.03% for 30-89 days and 0.27% for 90 plus days. Net charge-offs of residential mortgages remain manageable at $17 million in 2007 and $6.5 million for the first quarter of 2008. Foreclosed 1-4 family property is manageable at $48.5 million.[64]

The Texas Department of Savings & Mortgage Lending also testified that the strong Texas workforce and employment growth have isolated Texas from the severity of mortgage foreclosures and credit problems that other states face.[65]

> All state savings banks less than three years old, which represents 26% of the industry, are still experiencing operating losses. One additional charter with a significant mortgage presence nationwide has sustained heavy losses. Non-performing assets to total assets declined from 1.3% to 1.1% as of March 31, 2008. Number of problem institutions has increased from one at 8/31/07 to five as of today. The number of licensed mortgage brokers and loan officers and financial service agents has declined from 24,420 at August 31, 2007 to 22,862 as of June 9, 2008 – a 6% decline. The 2007 annual report showed that loan origination declined from $38.5 billion in 2006 to $29.0 billion in 2007, based on information received from 6,418 mortgage brokers.

Stakeholders also testified that the main reason Texas is not experiencing the high foreclosures seen in other states is because of our strong lending statutes. For example, in order for homeowners to preserve equity, the Texas Constitution capped the amount of a home equity loan at 80 percent of the home's value and has certain restrictions on home equity lines of credit and reverse mortgages.[66] In other states, such restrictions do not exist and consumers may obtain home equity loans that exceed the value of their home.

Another reason Texas is not experiencing the foreclosures seen in other states is because of the Texas Mortgage Broker Act, passed in 1999.[67] While many states lack regulation of mortgage brokers, Texas has strict licensing and regulation of mortgage brokers. For these reasons, the

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[64] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Deputy Commissioner Bob Bacon, Texas Department of Banking).

[65] *Impact of Foreclosure Problem in Texas & Responses from Financial Community: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Commissioner Doug Foster, Texas Department of Savings & Mortgage Lending). In 2007, Texas was ranked number one in employment growth in the nation.

[66] *See* TEX. CONS. ART. 16 § 50.

[67] *See* TEX. FIN. CODE § 156.

stakeholders and experts believe Texas will not see the level of severity of foreclosures and impact on the economy as other states.

Conclusion

The years 2007-2009 may be considered the perfect economic storm for the US economy: as gas prices increased, the price of food and other commodities increased, while the subprime lending market problems multiplied foreclosures, causing the decline in value of national housing market, which subsequently effected the financial institutions' ability to lend money which, in turn restricts credit for automobiles to education while investments, securities and retirement accounts plummeted. Ultimately, this storm will affect the taxing entities, which will ultimately affect all citizens, causing more problems for local, state and federal governments.

Despite this national bad news, Texas remains the economic anomaly. The economy and real estate market in Texas remain strong while employment growth continues as people move to Texas for economic opportunities. All research, data and testimony provided to the Committee suggests that Texas will not face the severity of the problems seen in other states.[68] While the number of foreclosures in Texas remains historically consistent, certain areas in Texas have higher foreclosures than other areas. The Committee will continue to monitor the issues to see what statutory changes need to be made.

[68] Unlike the 1980s, where Texas suffered an economic depression but other states did not have problems.

Practices Commonly Pointed Out as Predatory[69]		
Practice	Description	Texas Response
Equity Stripping	A predatory lender targets an individual with a great deal of equity in their home. The lender then loans a borrower more than the borrower can financially handle, knowing the borrower is likely to default. The lender can then foreclose on the home, stripping the homeowner of all equity earned.[70]	Home Equity Constitutional Protections: 1. Restricts the amount of equity that can secure the loan to 80% providing some equity remains with the homeowner 2. Restricts a borrower to one home equity loan per year limiting refinance fees and protecting the borrower's equity. 3. Texas Finance Code Protections for Second Mortgages: Ensures lenders evaluate a borrower's ability to repay before a loan is made ensuring that a lender's lending decision is not based solely upon a borrower's equity
Flipping	A predatory lender refinances a borrower's loans repeatedly within a short period of time. Each time the loan is refinanced, or flipped, the borrower is charged high fees, sometimes including prepayment penalties.[71]	Home Equity Constitutional Protections: Restricts a borrower to one home equity loan per year limiting refinance fees and protecting the borrower's equity Texas Finance Code Protections: Restricts lenders from contracting for prepayment penalties on loans with interest rates of 12% or greater to refinance a loan
Packing	The lender packs excessive fees, including unnecessary insurance coverage, other up-front charges, and additional junk fees (escrow waiver fees, fax fees, copy charges, etc.) into the loan agreement without the borrower's understanding. Often the fees far exceed what would be expected	Home Equity Constitutional Protections: Restricts a lender to 3% in fees limiting the ability of lenders to charge for certain reimbursable costs Texas Finance Code Protections for Second Mortgages: Limits lenders from collecting fees that are not reasonable or authorized
Insurance Packing	A predatory lender may add unwanted extras to the loan without the borrower's full knowledge. The most common product added to loans is credit life or disability insurance. In mortgage loans, the cost of credit insurance can be high. On a $28,000 loan, the cost of credit insurance can exceed $4,000. The $4,000 premium is added to the loan and financed over the life of the loan. The lender earns more interest on the loan and also earns a commission for selling the insurance.	Texas Finance Code Protections for Home Loans: Limits lenders from contracting for insurance where the premium is prepaid in a single installment, without providing a monthly premium alternative where the amount of the insurance is not included in the loan
Balloon Payments	A predatory lender reduces the monthly payment on a home loan by having the borrower pay off only the accrued interest each month. This will result in a huge balloon payment at the end of the repayment term, usually ranging from 10 to 15 years. The borrower often believes they are paying down the loan and is completely unaware of the balloon payment due at the end of the term. Elderly borrowers are often unable to refinance the loan, making foreclosure inevitable.	Home Equity Constitutional Protections: Prohibits lenders from contracting for balloon payments Texas Finance Code Protections for Second Mortgages: Prohibits lenders from contracting for balloon payments
Aggressive Marketing	Predatory lenders will offer bill consolidation equity loans encouraging consumers to pay off credit card, retail, and motor vehicle debt by consolidating them all into one home loan, promising lower monthly payments. While lower monthly payments do result from this transaction, the consumer trades short-term debt for long-term. Instead of paying off their bills in three to four years, it will now take them 15 to 30 years to pay. The consumer will also pay much more in interest over the life of the loan.	Home Equity Constitutional Protections: Requires lenders to provide certain disclosures to borrowers warning that failure to repay the loan could result in losing the home Texas Finance Code Protections: Requires lenders to provide a disclosure to a borrower warning that the loan could be considered a "high cost home loan" and directing the borrower to locations where counseling can be obtained

[69] Provided by Commissioner Leslie Pettijohn, Office of Consumer Credit Commissioner.
[70] Financial Crimes Enforcement Network, The SAR Activity Review: By the Numbers, Issue 5, February, 2006.
[71] Data as of February 10, 2006, found at www.FinCEN.gov/SARS/depository_insitution_SARS, Exhibit 5.

Fraud and Abuse	In many cases, lenders utilize fraud and abuse to prey on certain groups—the elderly, minorities, and individuals with lower incomes and less education—with deceptive or high-pressure sales tactics. [72]	Home Equity Constitutional Protections: Requires lenders to provide certain disclosures to borrowers warning that failure to repay the loan could result in losing the home Texas Finance Code Protections for Home Loans with Interest Rates of 12% or Greater: Requires lenders to provide a disclosure to a borrower warning that the loan could be considered a "high cost home loan" and directing the borrower to locations where counseling can be obtained Deceptive Trade Practices Act Protections: Restricts lender advertising and sales to ensure that the borrower is not mislead by misrepresentations and false claims

[72] The dates used in MARI's Fraud Index refer to when the fraud occurred, which are typically the loan origination dates. Subscribers to the MIDEX system may not discover that a loan involved fraud for several months, or even one or two years after it was originated, so numbers for recent years are dynamic. Financial Crimes Enforcement Network, *SAR Activity Review - Issue 10 May 2006*, United States Department of the Treasury, May 10, 2006. Available at: www.fincen.gov/sarreviewissue10.pdf. *See also* Merle Sharick, Erin E. Omba, Nick Larson &D. James Croft, *Eighth Periodic Mortgage Fraud Case Report*, April 2006, Mortgage Asset Research Institute, Inc., Virginia.

FINDINGS

1. The subprime lending products caused a dramatic increase in foreclosures. Texas has seen an increase in foreclosures but not to the extent seen in other states. The Texas real estate market remains strong and the overall economy remains strong.

2. The Texas Legislature should monitor the federal legislation and actions of the U.S Congress during the spring of 2009. The Texas Legislature should review the SAFE Act in the Housing and Economic Recovery Act of 2008 and conform the Finance Code to reflect the federal requirements. Failure to comply with these requirements will result in the U.S. Department of Housing preempting certain parts of the Finance Code.

MORTGAGE FRAUD

BACKGROUND

Mortgage fraud is a growing crime which affects individuals, companies and communities.[73] The effects of mortgage fraud to the residential lending industry range from monetary losses incurred by financial companies to criminal and administrative actions.[74] Consequences to the consumer are higher loan rates and fees, stolen identities, and possibly impaired credit ratings. These losses increase the cost of financing for consumers and increase risks to all participants in the mortgage process.

Ramifications to a neighborhood victimized by mortgage fraud can include higher property taxes, inability to sell homes, increased criminal activity and abandoned properties.[75] It often takes years for a neighborhood to recover from the damage caused by mortgage fraud.

While no federal law exists against mortgage fraud, federal prosecutors use statutes such as mail fraud, bank fraud, or wire fraud to charge perpetrators of mortgage fraud.[76] Currently, local, state and federal governments work together to resolve complaints about mortgage fraud.[77]

Types of Mortgage Fraud

The Financial Crimes Enforcement Network (FinCEN) is an agency under the U.S. Department of the Treasury that collects Suspicious Activity Reports (SARs) from all federally insured financial institutions.[78]

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[73] Mortgage fraud is different from predatory lending. While fraud by its nature is predatory, predatory lending usually is seen as misleading information, bate & switch advertising, purposefully designed to be confusing.
[74] *Impact of HB 716 & Mortgage Fraud Task Force: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008); *See also* Bill Analysis for House Bill 716, Texas Legislature, May 2007 available at: http://www.capitol.state.tx.us/tlodocs/80R/analysis/doc/HB00716S.doc
[75] *Id*.
[76] The federal statutes used to prosecute mortgage fraud include:
18 U.S.C. § 1001 - Statements or entries generally
18 U.S.C. § 1010 - HUD and Federal Housing Administration Transactions
18 U.S.C. § 1014 - Loan and credit applications generally
18 U.S.C. § 1028 - Fraud and related activity in connection with identification documents
18 U.S.C. § 1341 - Frauds and swindles by Mail
18 U.S.C. § 1342 - Fictitious name or address
18 U.S.C. § 1343 - Fraud by wire
18 U.S.C. § 1344 - Bank Fraud
42 U.S.C. § 408(a) - False Social Security Number
[77] The Federal Bureau of Investigation and the Mortgage Bankers Association jointly produced a Mortgage Fraud Warning Notice, which states:

> Mortgage Fraud is investigated by the Federal Bureau of Investigation and is punishable by up to 30 years in federal prison or $1,000,000 fine, or both. It is illegal for a person to make any false statement regarding income, assets, debt, or matters of identification, or to willfully overvalue any land or property, in a loan and credit application for the purpose of influencing in any way the action of a financial institution.

[78] Financial Crimes Enforcement Network, *SAR Activity Review - Issue 13 May 2008*, United States Department of the Treasury, May 2008. Available at: http://www.fincen.gov/news_room/rp/files/sar_tti_13.pdf.

There are two basic types of fraud in the residential mortgage industry: fraud for housing and fraud for profit.[79] Fraud for housing is usually perpetrated by home buyers/borrowers when they misrepresent or omit information on the loan application in order to obtain a loan for which they would normally not qualify.[80] Fraud for profit consists of systematic transactions by industry professionals who are attempting to steal a significant amount of the funds associated with one or more mortgage transactions.[81] Usually, fraud for profit involves one or more industry professionals (real estate agents, mortgage brokers, appraisers, title and escrow agents) misrepresenting information in a loan transaction in order to receive a commission on a loan that would not normally be acceptable to a lender.[82]

The true cause of mortgage fraud is the same cause of any fraud: the scam.[83] The main players seen in a mortgage fraud scam are listed below:[84]

- Borrower & Straw Borrower
- Borrower's Real Estate Agent
- Seller & Broker Owner
- Seller's Real Estate Agent
- Broker/Banker/Loan Officer/Processor/Underwriter
- Lender employee
- Title agent representative/ Fee attorney
- Appraiser
- Counterfeiter – appraisal reports "borrowed", cut and pasted/altered
- Appraiser Impersonator – borrowed another's number and credentials
- Bank employee – deposit verifications
- Fake employer – employment verifications
- Third party service provider
- Relative /friend /acquaintance

While FinCEN gathers information on mortgage fraud, the primary purpose of its data collection activities in the past has been to track money laundering. Further, the SARs only cover activities at federally insured financial institutions. A SAR is not required by state-chartered mortgage lenders that are not affiliated with an insured financial institution. Participants include, among others, the American Bankers Association; Independent Community, Bankers of America; American Institute of Certified Public Accountants; Securities Industry and Financial Markets Association; Futures Industry Association; Money Services Roundtable; Board of Governors of the Federal Reserve System; Office of the Comptroller of the Currency; Federal Deposit Insurance Corporation; Office of Thrift Supervision; National Credit Union Administration; U.S. Department of Justice's Criminal Division and Asset Forfeiture & Money Laundering Section and the Federal Bureau of Investigation; U.S. Department of Homeland Security's Bureau of Immigration and Customs Enforcement and U.S. Secret Service; U.S. Department of the Treasury's Office of Terrorism and Financial Intelligence, Internal Revenue Service, and the Financial Crimes Enforcement Network.

[79] *Id*.

[80] *Id*. Fraud for housing is not as financially catastrophic to a financial institution as fraud for profit.

[81] *Id*. Fraud for profit usually results in significant—if not catastrophic—losses to financial entities involved in mortgage loan transactions and is of major concern to the mortgage industry.

[82] *Id*.

[83] *Impact of HB 716 & Mortgage Fraud Task Force: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008); *See also* Bill Analysis for House Bill 716, Texas Legislature, May 2007. Available at: http://www.capitol.state.tx.us/tlodocs/80R/analysis/doc/HB00716S.doc

[84] *Hearing Before the House Comm. on Financial Institutions,* 2007 Leg., 80th Sess. (Tx.2007) (statement of Commissioner Danny Payne, Texas Department of Savings & Mortgage Lending).

Two exacerbating factors have combined over the past few years to pressure the industry into non-traditional practices that contribute to future fraud reports. First, there exists the ever-present drive to speed up the mortgage approval process. Second, escalating home prices in many markets drive up appraisals everywhere. Mortgage fraud can involve several factors, including:

- The use of multiple parties in various disciplines within the mortgage industry, such as mortgage originators, appraisers, real estate agents, closing agents, builders and title companies;
- Land flips, fictitious lien releases, and diversion of funds at closing;
- The use of a shell company to scam money from the legitimate deal;
- Over inflating appraisals and;
- Parties that know fraud is occurring, but do not stop or report it.[85]

The following examples are real estate scams most commonly seen in mortgage fraud SARS activity.[86]

> Mortgage rescue schemes. Seven of the sampled narratives described fraudulent mortgage rescue schemes. Fraud perpetrators preyed on individuals threatened with foreclosure of their homes. Typically, the home owner was told that if they signed a quit claim deed for the benefit of the rescuer, the mortgage would be paid and the homeowner could continue living in the house with the promise that the property would be deeded back when the homeowner was able to obtain refinancing. The rescuer recorded the quit claim deed and then sold the property. Whereas in these instances, the borrower was the victim of the fraud, another type of mortgage rescue scheme defrauded the lender. In these cases, borrowers participated as straw buyers to purchase property and then quit claim the property back to the seller. This was considered a type of mortgage rescue scheme since typically the sellers were in default when the transfers occurred.
>
> "Freeman in nature" schemes. Four reports described attempted fraudulent payoffs with "Freeman in nature" arguments. These arguments claimed that no money exchanged hands (i.e., the loan was merely a paper transaction), therefore there was no duty to repay the mortgage. Suspected Freeman schemes made up less than 1% of the sampled narratives, but they represent a danger to both lenders and homeowners. The reviewed Freeman schemes frequently resulted in the filing of fraudulent lien releases in county land records endangering the lender's loan security. Ultimately, homeowners who participate in these schemes lose their homes.

[85] *Id.*
[86] Financial Crimes Enforcement Network, *Mortgage Loan Fraud: An Update on Trends Based Upon An Analysis of Suspicious Activity Reports*, United States Department of the Treasury, April 2008. Available at: www.fincen.gov/MortgageLoanFraudSARAssessment.pdf.

Asset rental. Ten of the sampled narratives described suspected fraudulent attempts to temporarily inflate borrowers' assets in order to qualify them for loans. Typically, the borrower's name was added to an existing account. After the institution holding the account verified the assets in that account, the borrower's name was removed. Eight (80%) of these reports were submitted by the institutions that were requested to prepare verifications of deposit. The filers noticed that the funds were withdrawn or the names were removed shortly after a verification of deposit request was completed. These proactive reports demonstrated an awareness of this type of fraud and provided examples of successful industry efforts to identify them.

Fraudulent investment schemes. Borrowers obtained loans for multiple properties within a short period of time. Frequently the subject properties were located in states outside the borrower's home state. The fraudulent activities generally included appraisal fraud, occupancy fraud, fraudulent property flipping, forged or fraudulent documents, and misrepresentation of assets and debts. These schemes also included borrowers participating in fraudulent real estate investment schemes by agreeing to have their personal credit used to acquire mortgages in return for a fee plus the promise of additional commissions when the property was resold. Investors were told the properties would be renovated and sold in approximately one year, and that mortgage payments would be made with rental income. The fraudulent activities generally included appraisal fraud, asset rental fraud, occupancy fraud, straw buyer, and misrepresentation of assets and debts. Ultimately the borrowers were left owing mortgages that exceeded the property value.

Creating false down payments for properties. Activities included depositing advances from credit cards into bank accounts then using those funds to obtain official checks payable to a title company. The funds were later returned from the title company to the bank account. In reality, the property was obtained for no money down, while creating a false appearance to the lender that the borrower had made a down payment. Another variation reported was the disguising of purchase loans as refinance loans with no money down and possibly cash back at the time of settlement. In reality the property is transferred to the borrower at the time the "refinance" loan is closed. This type of activity increases the likelihood the borrower will default on the loan since the borrower has no financial vested interest, since their earnest money was funded by a loan.

Short payoff. Inflated appraisals were used to obtain the subject loans. Borrowers defaulted on the loans and claimed a fraudulent hardship, such as loss of employment or illness. The borrowers further claimed they were victims of appraisal fraud and requested that the lenders accept short payoffs. The proposed payoffs were based on legitimate appraisals that were significantly less (40 to 60 percent less) than the appraisals used to obtain the loans.

Fraudulent credit reports. Employees of a credit bureau changed credit reports to fraudulently improve credit profiles by removing legitimate negative information and adding positive information.[87]

House Bill 716 (80th Session)

During the 80th Regular Session of the Texas Legislature, Rep. Burt Solomons authored and Sen. Kip Averitt sponsored House Bill 716 - legislation to address mortgage fraud and enable district attorneys to prosecute these cases. House Bill 716 included "a mortgage loan" in the definition of credit.[88] House Bill 716 requires lenders, mortgage bankers or licensed mortgage brokers to provide a written notice to each applicant for a home loan at closing.[89]

House Bill 716 allows individuals to report fraudulent activity to the authorized governmental agency and established the Residential Mortgage Fraud Task Force, to form a partnership between state, federal and local authorities. The task force consists of the following persons or their appointees: the Attorney General, the Consumer Credit Commissioner, the Banking Commissioner, the Credit Union Commissioner, the Commissioner of Insurance, the Savings and Mortgage Lending Commissioner, the presiding officer of the Texas Real Estate Commission and the presiding officer of the Texas Appraiser Licensing and Certification Board.

The task force will focus its efforts on sharing information and resources as well as enforcing administrative and criminal actions against perpetrators of mortgage fraud. The Attorney General's Office oversees the administration of the task force and the task force submits an annual report on the progress of each member agency.

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[87] *Id.*

[88] House Bill 716 amended TEX. FIN. CODE § 343; TEX. GOVT. CODE §§ 402.031 & 402.032; TEX. GOVT. CODE § 411.1407; TEX. GOVT. CODE §551.051; TEX. PEN. CODE § 32.32; TEX. CRIM. PRO. CODE § 12.01.
See also Bill Analysis for House Bill 716, Texas Legislature, May 2007 available at:
http://www.capitol.state.tx.us/tlodocs/80R/analysis/doc/HB00716S.doc

[89] The notice includes the name, employment information and annual income information of the applicant. The notice will be a separate document in 14-point font and will include a warning to those involved in the process that intentionally or knowingly making false or misleading statements to obtain property, credit or a mortgage loan is a violation of Penal Code § 32.32 and, depending upon the amount of the loan or value of the property, is punishable by imprisonment and a fine. The loan applicant shall verify the information and execute the notice.

ANALYSIS

With increases in new house financing opportunities, the possibility of mortgage fraud also increases. FinCEN released the following data about the top ten states, which shows a dramatic increase in mortgage-related SARs.[90]

TOP 10 STATES WITH SARS REPORTS

STATE	2006 DEPOSITORY INSTITUTION SARS	2005 DEPOSITORY INSTITUTION SARS	PERCENTAGE OF CHANGE	2006 PROJECTED INCOME PER CAPITA	RANK IN US PER CAPITA INCOME
California	8,109	4,734	71.29%	$38,956	11
Florida	3,552	2,321	53.04%	$35,798	20
Illinois	2,477	1,409	75.80%	$38,215	13
Georgia	2,265	1,770	27.97%	$31,891	38
Texas	2,185	1,557	40.33%	$34,257	25
New York	1,797	1,228	46.34%	$42,392	5
Michigan	1,671	1,103	51.50%	$33,847	27
New Jersey	1,119	771	45.14%	$46,344	2
Arizona	1,050	706	48.73%	$31,458	39
Ohio	957	765	25.10%	$33,338	29

According to FinCEN, the top five states with the highest reports of mortgage fraud are California, Illinois, Florida, Georgia and Texas.[91] Based on the collected SARs data, the statistics below indicates the increased reports of suspected mortgage fraud.

> In calendar year 2006, financial institutions filed 37,313 SARs citing suspected mortgage loan fraud, a 44% increase from the preceding year, compared to a 7% overall increase of depository institution SAR filings. One reason for this increase may be that lenders are increasingly identifying suspected fraud prior to loan approval and reporting this activity. Suspected fraud was detected prior to loan disbursements in 31% of the mortgage loan fraud SARs filed between April 1, 2006 and March 31, 2007, compared to 21% during the preceding ten years.[92]

[90] Financial Crimes Enforcement Network, *Mortgage Loan Fraud: An Update on Trends Based Upon An Analysis of Suspicious Activity Reports*, United States Department of the Treasury, April 2008. Available at: www.fincen.gov/MortgageLoanFraudSARAssessment.pdf.

[91] *Id*.

[92] Financial Crimes Enforcement Network, *SAR Activity Review - Issue 13 May 2008*, United States Department of the Treasury, May 2008. Available at: http://www.fincen.gov/news_room/rp/files/sar_tti_13.pdf.
See also Financial Crimes Enforcement Network, *Mortgage Loan Fraud: An Update on Trends Based Upon An Analysis of Suspicious Activity Reports*, United States Department of the Treasury, April 2008. Available at: www.fincen.gov/MortgageLoanFraudSARAssessment.pdf

These changes in SARs figures, however, are not entirely reflective of increased fraud activity because only federally insured financial institutions and their affiliates are required to submit SARs reports. The fraud experiences of independent mortgage banking companies are not reflected. However, the number of mortgage originators covered by the SARs submission requirement has been growing significantly in recent years. Commercial banks and thrifts (which are required to make SARs) acquired almost 150 independent mortgage banks between 1997 and 2007.[93] Many of the acquired companies were among the largest originators in the country.

ACTIVITIES REPORTED IN SAMPLE SAR NARRATIVES[94]

ACTIVITY	No. of SARS	% of Sampled SARS
Misrepresentation of income/assets/debts	761	43.02%
Forged/fraudulent documents	496	28.04%
Occupancy fraud	255	14.41%
Appraisal fraud	232	13.11%
ID Fraud	180	10.18%
Straw buyers	100	5.65%
ID Theft	61	3.45%
Flipping	48	2.71%

Some factors which attribute to the occurrence of fraud include underwriters of loans who are not paying attention, equity stripping, escrow accounts, refinancing tax liens, internet lenders, lenders who are making loans the borrower cannot afford, unregulated credit repair companies, consumers who do not read the fine print on mortgage documents and consumers lacking education on mortgage products.[95] Also, the use of the technology, including the Internet, enables increased loan applications.

The growing faceless nature of these transactions increases the opportunities for fraud (especially identity fraud) and, coupled with "low-document" or "no-document" loans, creates an environment vulnerable to fraudulent activity. Using the Internet or telephone to receive and

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[93] Financial Crimes Enforcement Network, *Mortgage Loan Fraud: An Update on Trends Based Upon An Analysis of Suspicious Activity Reports*, United States Department of the Treasury, April 2008. Available at: www.fincen.gov/MortgageLoanFraudSARAssessment.pdf.
[94] *Id.*
[95] *Id.*

process mortgage loans means that lenders may never meet borrowers, even during the loan closing process. In some cases, lenders forward the loan documents to borrowers by courier service and the documents are returned to lenders in the same manner.[96]

LOAN TYPE COMPARISON FOR TYPE OF FRAUD[97]

LOAN TYPE	PROFIT	% LOAN TYPE	HOUSING	%LOAN TYPE
Purchase	440	34.00%	840	64.91%
Refinance	93	45.15%	112	54.37%
2nd Trust	20	47.62%	22	52.38%
Home Equity	38	61.29%	24	38.71%
Construction	19	100%	0	0%

Committee Hearing

On January 23, 2008, the Committee heard testimony on the issue of mortgage fraud in Carrollton, Texas. Because House Bill 716 created the Texas Mortgage Fraud Task Force, the Committee invited representatives from each state agency to testify on their experience with the task force.[98]

State agencies and local law enforcement look for warning signs of mortgage fraud, which include:

- Inflated appraisals
- Bonuses to brokers or fee-based providers POC or at closing
- Higher than customary fees
- Falsifications of income, deposits, rents, etc. (sometimes instructed as to how by broker)
- Fake supporting documentation
- Requesting documents be signed in blank
- Purchase loans disguised as refis w/cash outs
- Multi – sales – active title history
- Investment opportunities and guarantees

[96] Financial Crimes Enforcement Network, *Mortgage Loan Fraud: An Industry Assessment based upon Suspicious Activity Report Analysis*, United States Department of the Treasury, November 2006, p.8. Available at: http://www.fincen.gov/MortgageLoanFraud.pdf.
[97] Financial Crimes Enforcement Network, *Mortgage Loan Fraud: An Update on Trends Based Upon An Analysis of Suspicious Activity Reports*, United States Department of the Treasury, April 2008. Available at: www.fincen.gov/MortgageLoanFraudSARAssessment.pdf.
[98] The state agencies on the task force are the attorney general, the consumer credit commissioner, the banking commissioner, the credit union commissioner, the commissioner of insurance, the savings and mortgage lending commissioner, the presiding officer of the Texas Real Estate Commission and the presiding officer of the Texas Appraiser Licensing and Certification Board.

- Terms too good to be true
- High pressure tactics employed
- Unexplained excessive fees/costs
- Requiring “prepayment” of certain disallowed fees
- Investment opportunities outside of the transaction but in connection with
- Multi-level services offers
- Does not have/advertise a physical business address
- Does not disclose license number
- Bait and switch advertising[99]

Since the Texas Attorney General's Office oversees the administration of the task force, David Glickler and James Daross testified on behalf of the agency. The Attorney General's Office receives many complaints about mortgage fraud; however, given the current real estate market, many complaints involve foreclosure issues, not mortgage fraud. Upon receipt of a complaint, the Attorney General's Office works with local law officials and district attorneys to investigate the complaints. Since enactment of House Bill 716 on September 1, 2007, the Attorney General's Office has investigated 93 complaints and has 15 open cases.[100]

Deputy Commissioner Robert Bacon of the Texas Department of Banking testified that the Department received less than 30 complaints on commercial construction loans, which could involve fraud.[101] Dennis Pompa of the Texas Department of Insurance testified that the Department received 28 reports of fraudulent activity involving escrow officers and title agents from September 1, 2007 to January 22, 2008.[102] Rudy Aguilar of the Texas Office of Consumer Credit Commissioner informed the Committee that they received 68 complaints involving mortgage fraud since September 1, 2007.[103] Each agency representative testified that the coordinated efforts with the Attorney General's Office have assisted each agency with their mortgage fraud complaints.

Commissioner Doug Foster of theTexas Department of Savings and Mortgage Lending testified that most complaints the Department receives are not mortgage fraud issues, but non-compliance issues.[104] While the task force is working together, the Attorney General's Office puts priority on their agency cases and not the other agencies' complaints. Tim Irvine of the Texas Real Estate

[99] *Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. (Tx. 2007) (statement of Commissioner Danny Payne, Texas Department of Savings & Mortgage Lending).

[100] *Impact of HB 716 & Mortgage Fraud Task Force: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of David Glickler and James Daross, Office of Texas Attorney General).

[101] *Impact of HB 716 & Mortgage Fraud Task Force: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Robert Bacon, Texas Department of Banking). The Department handles mostly commercial lending.

[102] *Impact of HB 716 & Mortgage Fraud Task Force: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Dennis Pompa, Texas Department of Insurance).

[103] *Impact of HB 716 & Mortgage Fraud Task Force: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Rudy Aguilar, Texas Office of Consumer Credit Commissioner).

[104] *Impact of HB 716 & Mortgage Fraud Task Force: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Doug Foster, Texas Department of Savings and Mortgage Lending).

Commission and the Texas Appraiser Licensing & Certification Board testified that the Commissions have revoked 17 licenses since HB 716's enactment.[105] Betsy Loar of the Texas Credit Union Department testified that the Department has not received any reports of mortgage fraud at the time of this hearing.[106]

The Committee also heard public testimony on mortgage fraud.[107] The Texas Association of Realtors, the Texas Land & Title Association and the Dallas Ft. Worth Association of Mortgage Brokers testified that they encourage their members to report fraudulent activity. They also stated that education on mortgage fraud has helped identify and catch the perpetrators of mortgage fraud.

The Committee asked the invited and public speakers whether the legislation was working and whether the notice disclosure was reducing false or misleading information on residential home loan applications. The speakers testified that the notice greatly assists district attorneys and law enforcement with prosecuting mortgage fraud cases. A sample of the Mortgage Fraud Notice is attached below.

The task force will submit a report to the Legislature in late fall 2008 on the progress of House Bill 716. Based on the findings of the report, the Legislature will determine if additional legislation is necessary to assist with the prosecution of mortgage fraud.

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[105] *Impact of HB 716 & Mortgage Fraud Task Force: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Tim Irvine, Texas Real Estate Commission & Texas Appraiser Licensing & Certification Board).

[106] *Impact of HB 716 & Mortgage Fraud Task Force: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Betsy Loar, the Texas Credit Union Department).

[107] *Impact of HB 716 & Mortgage Fraud Task Force: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Lori Levy, Texas Association of Realtors, Roland Love Texas Land Title Association, Martin Sisk, Dallas Ft Worth Association of Mortgage Broker, James Ratliff and Connie Rowe).

MORTGAGE FRAUD NOTICE

NOTICE OF PENALTIES FOR MAKING FALSE OR MISLEADING STATEMENT*

Effective September 1, 2007 and pursuant to Section 1, Subchapter B, Chapter 343, Section 343.105 of the Texas Finance Code, each mortgage lender, mortgage banker or licensed mortgage broker/loan officer shall provide to each applicant for a home loan this written notice at closing for full verification and execution by each loan applicant.

WARNING:
Intentionally or knowingly making a materially false or misleading statement to obtain property or credit, including a mortgage loan, is a violation of Section 32.32, of the Texas Penal Code, and, depending on the amount of the loan or value of the property, is punishable by imprisonment for a term of 2 years to 99 years and a fine not to exceed $10,000.00.

I/we, the undersigned home loan applicant(s), represent that I/we have received, read, and understand this notice of penalties for making a materially false or misleading written statement to obtain a home loan.

I/we represent that all statements and representations contained in my/our written home loan application, including statements or representations regarding my/our **identity, employment, annual income, and intent to occupy the residential real property** secured by the home loan, are true and correct as of the date of loan closing.

____
Applicant Date

____
Co-Applicant(s) Date

1/18/2008

Office of the Attorney General
Mortgage Fraud Task Force - Statistics

	Citizens	DA	SML	TDI	HUD	TALCB	OAG	Private Affiliate	FBI	TOTAL
Total Inquiries Received by OAG	69	2	1	8			1	12		93

Actions Taken by MFTF

	Citizens	DA	SML	TDI	HUD	TALCB	OAG	Private Affiliate	FBI	TOTAL
Inquiries *Pending* Review or Determination of Action	2							1		3
Inquiries Closed/NFA: Determined non-MF[1]	19							3		22
Inquiries Closed/NFA: Investigation In Process by Other Entity[2]		3	1						1	5
Inquiries NFA: Pending Receipt of Additional Information[3]	12							2		14
Referrals Made Directly to Other Entity by OAG		10				2				12
Referred Citizens to Other Entity	3	10	7	2	4	2				28
Inquiries Assigned for OAG-CID Investigation	5	1		6			1	1		14
Inquiries Assigned for OAG-CPD Prosecution		1								1
MFTF Speaker Requests	1									1

County DA Referrals	
Collin County DA	3
Comal County DA	1
Dallas County DA	13
El Paso County DA	1
Harris County DA	2
Tarrant County DA	1
Travis County DA	3
	24

[1] *foreclosure rescue scam, general fraud, civil matter, etc*
[2] *county / district attorney, state, local or federal law enforcement, state or federal regulatory entity, private attorney*
[3] *initial review - possible mortgage fraud*

FINDINGS

The Legislature should continue to monitor the progress and implementation of House Bill 716 (80th Session). The Residential Mortgage Fraud Task Force is investigating complaints of mortgage fraud. The task force will submit a report to the Legislature before the 81st Legislative Session. Based on the report, the Legislature should determine if additional legislation is necessary to assist with the prosecution of mortgage fraud.

PREPAID FUNERAL BENEFITS CONTRACTS

BACKGROUND

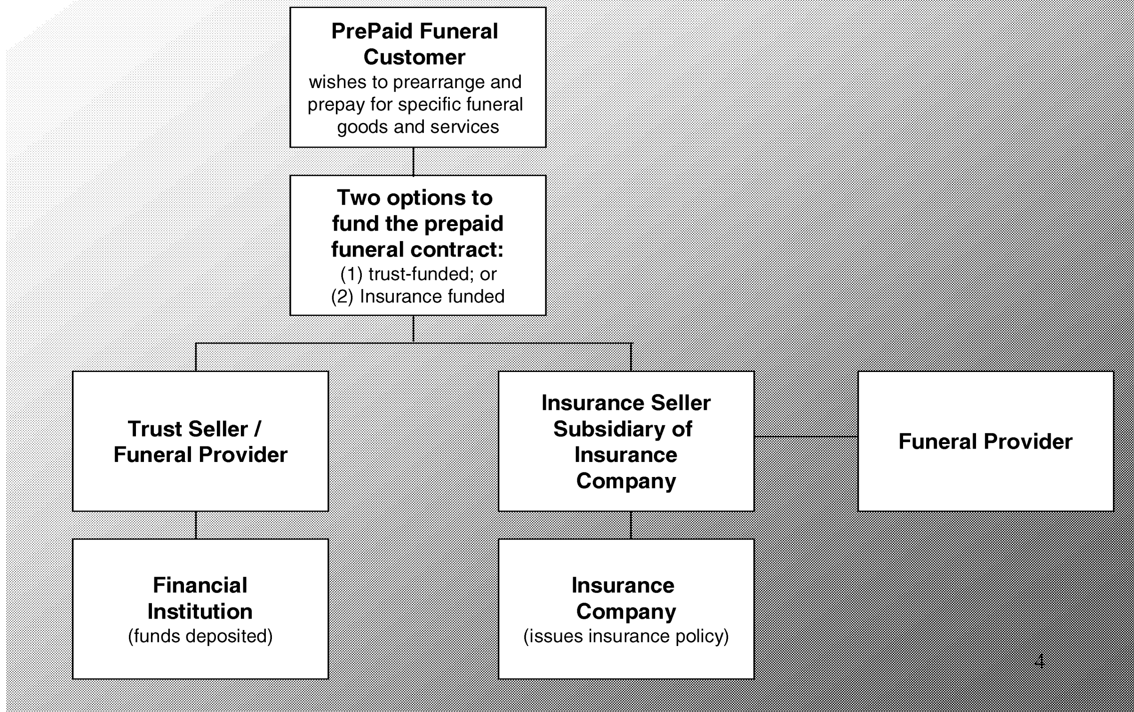
Overview

Planning for death is a process most people choose to avoid. Those who choose to prepare for life's inevitable journey can purchase a prepaid funeral benefits contract[108] (also called a pre-need funeral benefits contract).[109]

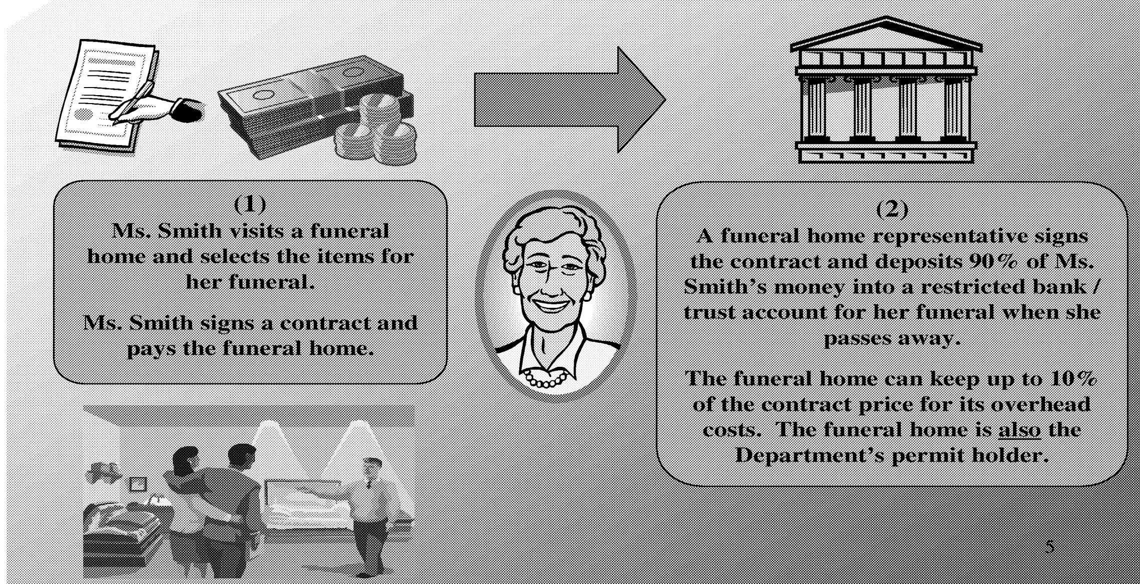
Regulatory oversight of prepaid funeral contracts is complex and involves three agencies: Texas Department of Banking (hereinafter "DOB"), Texas Department of Insurance (hereinafter "TDI") and the Texas Funeral Service Commission. DOB issues permits for the sale of prepaid funeral contracts and regulates permit holders.[110] TDI regulates and licenses insurance companies and agents.[111] The Texas Funeral Service Commission regulates and licenses funeral providers/establishments.[112]

Consumers have a choice in how to fund their prepaid funeral benefit contract. Two basic types of prepaid funeral contracts are available to consumers: trust-funded and insurance-funded contracts. Most permit holders offer only one type of contract. The diagram illustrates the process. [113]

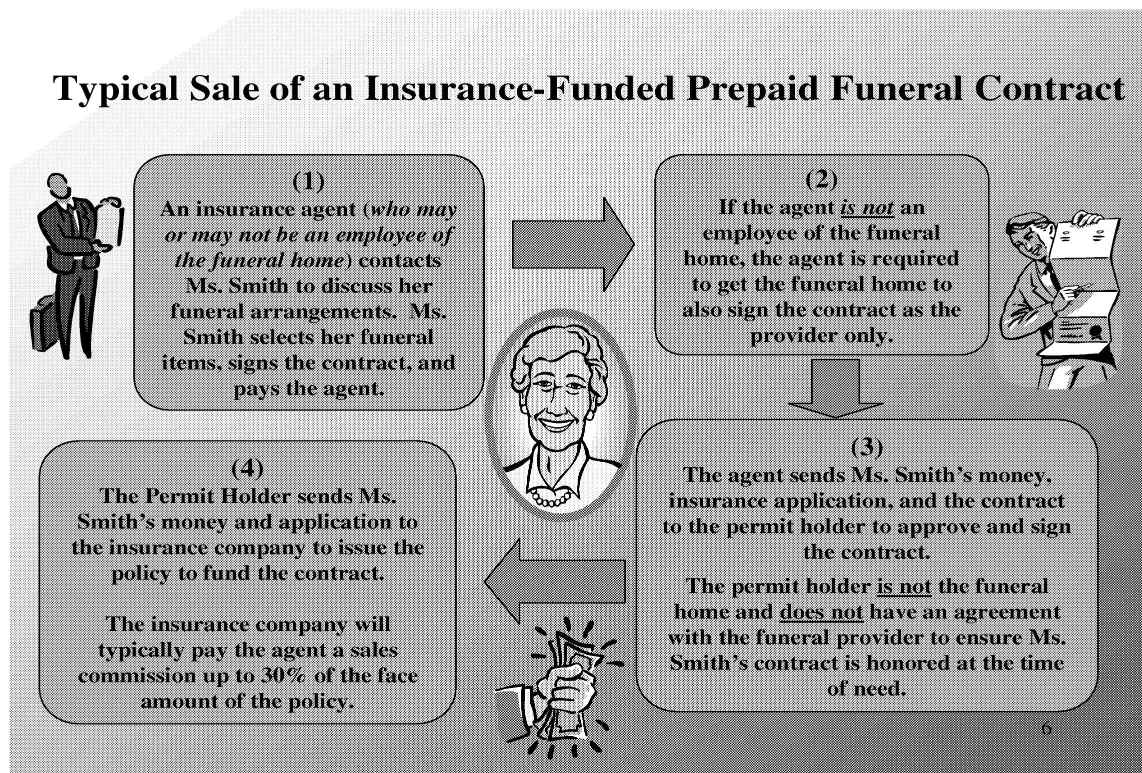
[108] The term "prepaid" and "preneed" are interchangeably used by the industry. For the purposes of this report, the term "prepaid" will be used, unless quoting an industry expert's statement.
[109] According to the Texas Funeral Services Commission, approximately 30% of funerals conducted in Texas involve a prepaid funeral contract. Usually, a person will purchase through an agent affiliated with a funeral home or independent insurance agent.
[110] *Discussion of Regulation of Prepaid Funeral Benefits: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of the Texas Department of Banking); *See* TEX. FIN. CODE § 154.
[111] *Discussion of Regulation of Prepaid Funeral Benefits: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of the Texas Department of Insurance); *See* TEX. INS. CODE.
[112] *Discussion of Regulation of Prepaid Funeral Benefits: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of the Texas Funeral Services Commission); *See* TEX. OCC. CODE § 651.
[113] Illustrations provided by the Department of Banking, April 2008.



For trust-funded contracts, a consumer pays into a deposit account or trust fund where the money is invested to accrue capital gains and interest.



An insurance-funded contract is funded by a single life insurance policy purchased by the consumer which identifies an insurance beneficiary to receive the policy proceeds at the time of death.[114] This beneficiary is most often the funeral provider or a trust that will be used to pay the funeral provider. Various types of life insurance products are currently used to fund prepaid funeral contracts – annuity contracts, single pay life policies, multiple pay life policies, etc. Purchasers typically are not offered a choice of insurance products for funding, but rather are offered the particular life insurance product sold by the insurance company with which the funeral home does business. The funeral home agrees to provide the funeral in exchange for the life insurance policy proceeds.[115] Subject to certain limitations, contractual obligations arising under a life insurance policy or annuity contract are guaranteed by the Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association which guarantees payment of the life insurance account value to the beneficiary of that contract.[116]



The Prepaid Funeral Guaranty Fund was created to guarantee performance and funding of trust-funded prepaid funeral contracts.[117] This fund has been determined to apply only to trust-funded prepaid funeral contracts. Because of this basic difference in the guaranty funds (guarantee of

[114] Sunset Advisory Commission, *Staff Report on the Funeral Service Commission*, p. 64 (2000).
In 1999, of the more than 840,000 prepaid funeral contracts in Texas, 510,370 were trust-funded and 332,627 were insurance-funded. The net worth of these contracts was $1.9 billion.
[115] *Discussion of Regulation of Prepaid Funeral Benefits: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of the Texas Department of Insurance).
[116] *See* TEX. INS. CODE § 463.
[117] *See* TEX. FIN. CODE § 154.351.

funding vs. guarantee of funding and performance), the guarantee provided for trust-funded contracts is different than for insurance-funded contracts.

The DOB's Special Audits Division oversees the Prepaid Funeral Contract Licensees.

Texas Department of Banking - Special Audits Division[118]

	Number of Permits	Number of Contracts	Dollars
Trust Funded	**352**	**359,167**	**$0.942 Billion***
Insurance Funded	**56**	**479,140**	**$2.134 Billion***
TOTALS	**408**	**838,307**	**$3.076 Billion**

Chapter 154 of the Texas Finance Code stipulates that the records of prepaid funeral contract sellers (permit holders) are subject to annual examination or more frequently as considered necessary to protect the prepaid funds and to assure that the contracted services and merchandise are provided at the time of death.[119]

ANALYSIS

In an effort to resolve regulatory issues related to insurance funding of prepaid funeral benefit contracts, DOB meets periodically with TDI to discuss the problems and possible legislative solutions. During the 80th Legislative Session in 2007, Representative Dan Flynn introduced House Bill 3436, the result of study and recommendations of both DOB and TDI.

House Bill 3436 sought to tie a prepaid funeral contract and the funding insurance product so that the two are considered one transaction for regulatory purposes.[120] Due to the complex regulatory nature of prepaid funeral benefit contracts, Representative Flynn requested this issue to be further studied as part of the Committee's interim report.[121]

[118] Texas Department of Banking, Data as of 12/31/2007; * Insurance is the total value of the death benefit under an insurance policy/PFC contract while trust is the amount paid in to date on contract.
[119] TEX. FIN. CODE § 154.053.
[120] Statement from Representative Dan Flynn on House Bill 3436, before the Texas House Committee on Financial Institutions, April 16, 2007.
[121] *Id.*

Committee Hearing

On April 2, 2008, the Committee heard testimony on the issue of prepaid funeral benefits. The main concerns of the Committee revolved around the following issues:

1. Lack of record-keeping in the transaction
2. Lack of consumer disclosures and transparency in the process
3. Lack of funds for contracts if solvency occurs
4. Lack of promulgated forms to modernize the process

In addressing the Committee's concerns, DOB testified that insurance-funded permit holders claim they have no legal or statutory responsibility or ability to maintain records or verify that a prepaid funeral contract (PFC) is properly honored at the time of need.[122] Provisions in the Finance Code regulating prepaid funeral benefit contracts do not reflect an insurance business model. The problem that no contractual agreements are made between the funeral provider and the permit holder is illustrated below:

> At the time of need, a funeral provider who sold the prepaid contract as the insurance-funded permit holder's agent overcharges a family $500 for a casket specified and purchased on the prepaid contract. The insurance-funded permit holder states it is not responsible for the actions of funeral providers and is not responsible to refund any overcharges.[123]

DOB testified that the industry lacks consumer disclosures and transparency in the process. There are no consumer disclosures that tell the purchaser:

1. He may be buying more insurance than is necessary to fund a prepaid funeral contract.
2. Depending on his age, health and type of policy issued, he may pay substantially more than the actual prepaid contract total.
3. Cancellation cash surrender values are substantially less than amounts paid in.
4. Assignment of the ownership of the insurance policy allows the assignee (often the permit holder or a trust) to control the policy including actions such as cancellation and pledging of the policy.[124]

One problem DOB encounters is abandoned permits. This occurs when an insurance-funded permit holder abandons its permit. After the permit is abandoned, there is no entity responsible to maintain the prepaid contract records or verify performance of the terms of the prepaid funeral contract at the time of death. The insurance company holding the policies may not even be aware that the death benefits are to be used to fund a prepaid funeral contract because the prepaid funeral contract is not required to be "linked" to the policy. For example, Magna Financial Services, Inc. abandoned its insurance-funded permit in 2001 with 1,169 outstanding contracts

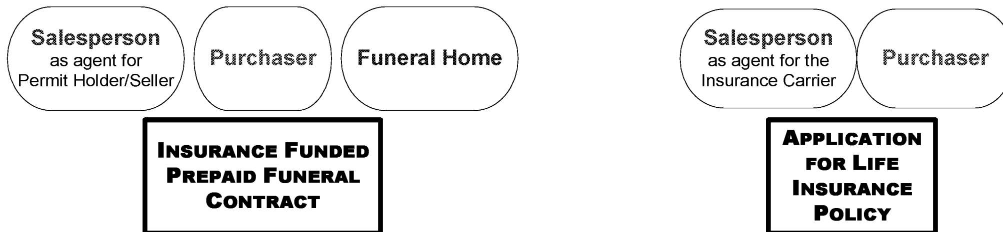
[122] *Discussion of Regulation of Prepaid Funeral Benefits: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of the Texas Department of Banking).
[123] *Id.*
[124] *Id.*

representing a total death benefit of $4,087,660.[125] IEIS Fidelity Plan, Inc. abandoned its permit in 2004 with 1,957 outstanding contracts representing a total death benefit of $6,948,575.[126]

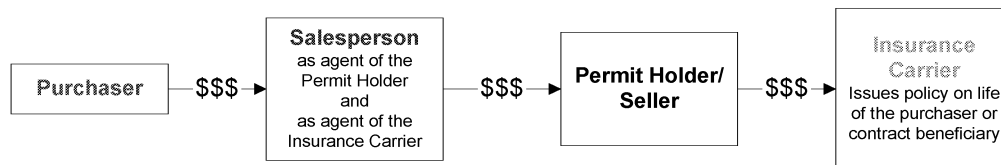
In addition, the insurance policy that funds a prepaid funeral contract is not required to pay any growth. This can leave the funeral provider with less than sufficient funds to pay for the funeral at the time of need due to increased funeral costs.

The following chart illustrates the basic process for prepaid funeral contracts; however, there are many different business models that vary within this process, particularly with respect to the entity that holds ownership of the insurance contract and the entity that is beneficiary of the insurance proceeds.

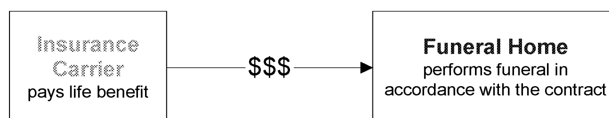
Insurance Funded



Flow of Money Upon Purchase



Flow of Money Upon Death of Contract Beneficiary



[125] *Id.*
[126] *Id.*

TDI regulates general and specialty agent licenses and oversees the financial solvency of insurance companies and related holding companies.[127] The Texas Life, Accident, Health, and Hospital Service Insurance Guaranty Association insures the face amount of the policies in case of insurance company insolvency, but not the "growth" of the policy.[128] Based on 2007 data, 56 insurance companies with TDI permits offer pre-need policies in Texas and annual premium volume by line is $86,777,803.[129] Approximately 60 percent of prepaid funeral contracts are insurance-funded.[130]

TDI does not have promulgated forms for policies used to fund prepaid funeral benefits contracts.[131] TDI requires the insurance companies to file copies of their own forms with them, but there are no standard forms used by the industry.[132] The total number of forms approved by TDI is 374 for the 56 permit holders.[133] However, of the 56 permit holders, only 35 are currently selling prepaid funeral contracts. Permit holders currently selling have an average of 10.7 approved policy forms each.

The Texas Funeral Service Commission regulates 1300 funeral homes, their funeral directors, 250 cemeteries and 97 crematories in Texas.[134] While the Commission does not regulate or oversee the prepaid funeral contracts, pursuant to an interagency agreement, it receives related complaints and forwards them to DOB or TDI.[135] The Commission does not have the audit capabilities to regulate the prepaid funeral benefit licensees, unlike DOB or TDI which both have audit capabilities.

The Committee's questions to DOB, TDI, and the Funeral Service Commission focused on the transparency in the process, disclosure of the process to the consumers, standardization of the forms used in the process and thorough record keeping procedures. While the agencies acknowledged that many of the problems can only be resolved through statutory changes, the agencies continue to work together with the interested stakeholders to address some problems through the rule-making process.

Several stakeholders testified at the hearing, including representatives from the funeral and insurance providers.[136] Several funeral providers testified about their interaction with prepaid

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[127] *Discussion of Regulation of Prepaid Funeral Benefits: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of the Department of Insurance).
[128] *Id.*
[129] *Id.*
[130] *Id.*
[131] *Id.*
[132] *Id* .
[133] *Id.*
[134] *Discussion of Regulation of Prepaid Funeral Benefits: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of the Texas Funeral Services Commission).
[135] *Id.*
[136] Stakeholder who testified at the hearing or submitted written testimony include Jim Bates (Funeral Consumers Alliance of Texas), Paul Beaty (Texas Funeral Directors Assoc.), Debra Colon (Columbian Life Insurance Company), Tracy Kelly (Homesteaders Life Company), Susan Thomas (Preneed Funeral Licensee; Insurance Executive), Joe Mann (Funeral Home director), Mike Pollard (Texas Association of Life & Health Insurers), Kris

funeral benefits.[137] They submitted written testimony which included their own sample forms and disclosures used in the course of business. The sample given described the process for servicing an insurance-funded prepaid funeral contract at the time of death:

1. The family comes to the funeral home and sits down with a licensed funeral director to finalize arrangements.
2. If the funeral is conducted by the selling funeral home:
   - A new at-need contract must be written to show that all services and merchandise were provided as listed on the pre-need funeral contract. This contract must be signed by the next of kin or deceased's personal representative.
   - A Certificate of Performance must be signed by the next of kin or deceased's personal representative and the funeral director. This Certificate of Performance states that all obligations have been performed.
3. If the funeral is conducted by a different funeral home than sold the insurance-funded pre-need contract:
   - The new funeral home must first agree to honor the pre-need funeral contract. (Instances in which the new funeral home might not agree are that the original contract was so out of date, that the merchandise is no longer available or the new funeral home would be losing a significant amount of money by agreeing to service the contract.)
   - If the new funeral home does agree to service the contract, then the process is the same as stated in 2.
   - If the new funeral home does not agree to service the contract, then the family may choose another funeral home or use the cash value of the pre-need as credit toward the funeral home charges.
4. The funeral home will not be paid for the insurance-funded pre-need until the following items are supplied to the insurance company.
   - A copy of the At-need contract signed by the next of kin or deceased's personal representative
   - A copy of the Certificate of Performance signed by the next of kin or deceased's personal representative and the funeral director
   - A copy of the Death Certificate [138]

Due to overlaying regulatory jurisdictions, the Committee solicited the opinions of all stakeholders as to which agency should regulate the process. When asked which agency they believe would be the best choice to regulate the prepaid funeral markets, the funeral provider

Seale (Funeral Directors Life Insurance Company, Funeral Agency, Inc.) & Leanne Shay (Great Western Insurance Company).

[137] *Discussion of Regulation of Prepaid Funeral Benefits: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Paul Beaty, Beaty Funeral Home, Joe Mann, Funeral Home Director, and Kris Seale, Funeral Directors Life Insurance Company).

[138] *Discussion of Regulation of Prepaid Funeral Benefits: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Paul Beaty, Beaty Funeral Home).

stakeholders replied that the current regulatory structure is best for everyone due to its checks and balances.[139]

The insurance industry stakeholders also testified. Some of the insurance industry stakeholders are members of the Texas Preneed Coalition, a group of 12 insurance companies that hold or are affiliated with companies that hold Texas prepaid funeral benefit permits.[140] Stakeholders stated:

> Texas preneed sellers are now required to comply at unrealistically high levels...In no other state does the preneed regulatory agency establish such intricate requirements, routinely monitor performance down to the individual contract level and conduct examinations to such thorough detail…Due to meticulous examination routines and elevated compliance standards in Texas, insurers that are permit holders see each new policy issue in Texas requiring twice the level of attention of a similar policy issued in any other state. Examiners require quarterly and annual reconciliation of contracts and related funds to balance contract counts and funds. The majority of these requirements have no statutory authority. Only annual accounting for permit renewal and reports for an exam period are specified in statute.[141]
>
> One preneed insurer has recently left the preneed market in Texas due to the high cost of compliance and the exhaustive nature of the Department of Banking's auditing practices.[142]
>
> The current regulation of the market requires insurance companies and other non-provider permit holders to be the conduit for the enforcement of how those preneed contracts are performed by funeral providers…requiring non-provider permit holders to police the actions of funeral providers is impossible in many situations since the funerals have already been provided and the provider's performance is not a controllable issue for anyone. Insurance companies find ourselves in the unique position of 'policing' the funeral industry on behalf of a state regulator. Preneed seller has no control over the delivery of goods and services listed in the preneed contract.[143]

The Committee members questioned why the insurance industry stakeholders do not believe that DOB should have auditing authority over the insurance-funded aspect of the prepaid funeral

[139] *Id.*
[140] *Discussion of Regulation of Prepaid Funeral Benefits: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Tracy Kelly, Homesteaders Life Company, and Leanne R. Shay, Great Western Insurance Company).
[141] *Id.*
[142] Written testimony from Debra Colon stated that Columbian Life Insurance Company discontinued in December 2005 "actively marketing preneed insurance in the State of Texas due to high cost and exhaustive nature of the preneed regulations in the State." The company still has contracts in effect, but no new policies.
[143] *Discussion of Regulation of Prepaid Funeral Benefits: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Tracy Kelly, Homesteaders Life Company, and Leanne R. Shay, Great Western Insurance Company).

benefit contracts, especially with the lack of transparency and record-keeping in the process. Stakeholders suggested that the preneed market would be better regulated by the Funeral Services Commission or TDI, because they do not believe the DOB has the authority to regulate insurance products.[144] The Committee suggested that the process must be standardized with better recording-keeping and promulgated forms.

Recent Developments

On April 9, 2008, TDI and DOB issued orders against National Prearranged Services (NPS) of St. Louis.[145] NPS sells prepaid funeral contracts in several states and is licensed in Texas by the DOB to sell insurance-funded prepaid funeral benefits contracts.[146] NPS has approximately 39,000 insurance-funded prepaid funeral benefits contracts outstanding in Texas.[147]

TDI issued a "Hazardous Financial Condition Order for Memorial Service Life Insurance Company (Memorial), Lincoln Memorial Life Insurance Co. (Lincoln), and National Prearranged Services, Inc. pursuant to Chapter 404 of the Texas Insurance Code."[148] At the same time, DOB "entered into an Agreed Order with National Prearranged Services, Inc., to cease selling prepaid funeral benefits contracts pursuant to Chapter 154 of the Texas Finance Code."[149]

In 2006, TDI became aware "when a significant amount of surrendered transactions were reported and the Department initiated appropriate oversight based on those reports."[150] This situation became more complicated due to management decisions of the non-insurance companies that are not under the regulatory authority of either TDI or DOB.[151] TDI placed the companies under supervision; under Texas law, if a company is placed under supervision, and there is guaranty fund protection, the supervision is required by statute to be a confidential supervision.[152] DOB became aware of the financial problems at NPS in December of 2007.[153]

The organizational relationship of Memorial, Lincoln, and NPS was so financially interrelated that the companies failed as a unit. According to the Departments, Texas consumers with prepaid

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[144] *Id.*
[145] *NPS Joint Press Release: Insurance, Banking Departments Issue Orders on Companies Involved With Pre-Need Funeral Contracts,* Texas Department of Insurance & Texas Department of Banking, April 9, 2008.
[146] *Id.*
[147] *Id.*
[148] NPS is a general agent for Lincoln Memorial Life Insurance Company and Memorial Service Life Insurance Company. NPS is ultimately owned by a Trust created by the Cassity family in the state of Missouri.
[149] *Id*; The Department of Insurance's Order requires the companies to establish a plan to pay policyholder claims and to address existing contracts. The Department of Banking Order requires NPS to cease selling prepaid funeral benefits contracts in Texas and requires NPS to take actions to comply with Chapter 154 of the Texas Finance Code for outstanding contracts and to return all prepaid funeral benefits contracts and associated payments received since March 17, 2008 to the purchasers. The Order also requires NPS to initiate actions to remove NPS as the policy beneficiary for polices issued in conjunction with Texas prepaid funeral benefits contracts.
[150] *Briefing Points on National Prearranged Services of St. Louis, Lincoln Memorial Life Insurance Company and Memorial Service Life Insurance Company*, Department of Insurance & Department of Banking, April 9, 2008.
[151] *Id.*
[152] *Id.*
[153] *Id.*

funeral benefit contracts with NPS "can expect that the policies will be paid up to the face amount."[154]

However, these policies did not include a "growth" provision and due to the financial inability of NPS, the 650 Texas funeral homes with NPS contracts will not receive any of the additional compensation NPS promised to them to address price inflation. This could adversely affect funeral providers in situations where the insurance benefits are not enough to cover the current cost of the contracted funeral.[155] Due to the financial implications, several Texas funeral home providers have filed lawsuits against NPS in this matter and the cases are pending in federal court.

The Departments are working very closely with other states' regulators to facilitate the oversight of NPS and its affiliates for the protection of consumers.[156] Texas seems to be faring better than some other states, perhaps due to its inclusion of periodic examinations in its regulation of prepaid funeral contract sellers.

[154] *NPS Joint Press Release: Insurance, Banking Departments Issue Orders on Companies Involved With Pre-Need Funeral Contracts,* Department of Insurance & Department of Banking, April 9, 2008.
[155] *Id.*
[156] *Id.*

FINDINGS

1. Chapter 154 of the Texas Finance Code does not adequately address the state of prepaid funeral benefit funding and performance. The Committee determined that the process lacks adequate record-keeping and consumer disclosures. The state agencies need promulgated forms to modernize the process.

2. The Legislature should specify and clarify the following: the characteristics of a life insurance policy appropriate for funding prepaid funeral contracts, the responsibilities of a permit holder and who can be a permit holder, and limitations on the discretion of a trustee named as insurance policy owner or beneficiary for the benefit of a contract purchaser.

3. The Legislature should specify transparency in prepaid funeral benefit contracts, delineate which state agency regulates and has enforcement authority over the contract. The Legislature should review the funding and guaranty mechanisms of prepaid funeral benefits contracts in the event of insolvency of the insurance company.

4. If the Legislature decides to restructure the regulation of insurance-funded prepaid funeral benefits, appropriations will be required to transfer prepaid funeral benefit audits from the Department of Banking to a different agency.

AUTO FINANCING

BACKGROUND

Overview

Buying a car is one of the largest purchases a consumer makes. In Texas several agencies regulate and license various parts of the transactions. The Texas Department of Transportation (hereinafter "TxDOT") licenses and regulates the sale of motor vehicles.[157] The Texas Office of Consumer Credit Commissioner (hereinafter "OCCC") licenses and regulates the financing of motor vehicle sales.[158]

Due to the consumer complaints received by the OCCC and legislation arising from those complaints during the 80th Legislative Session, the Committee was charged to study the practices involved in the sale and financing of a motor vehicle, including conditional delivery, negative equity and retirement of existing debt on vehicle trade-in.[159]

Conditional Delivery

A motor vehicle dealer will often condition the financing of motor vehicle upon the dealer's ability to sell the retail installment sales contract (i.e. the contract that documents the financing) to another company.[160] This "conditional delivery" is also called "spot delivery."[161] However, most consumers do not understand the consequences of a conditional delivery agreement. Most conditional delivery agreements allow the motor vehicle dealer to declare whether the motor vehicle to be returned and assess costs for use of the vehicle. This unilateral power is one aspect of conditional delivery agreements that most consumers do not understand.

The sale of the retail installment contract may take up to two months, if the motor vehicle dealer is able to sell it. If the dealer is unable to sell the underlying retail installment contract the consumer will usually have two options under the conditional delivery agreement: 1). renegotiate the terms of the contract, which usually requires a larger down-payment or a higher finance charge or 2). have the vehicle repossessed.[162] As Commissioner Pettijohn of the OCCC explained:

> Conditional delivery contracts often result in difficult situations for both dealers and buyers when the dealer tries to unwind the deal, especially when a significant

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[157] The agency licenses and regulates car dealerships and receives consumer complaints about the business practices of dealers, failure to pass title, the "lemon" law, and frauds such as odometer rollbacks.
[158] *See* TEX. FIN. CODE § 348.
[159] The Committee's intent for this interim charge is not to affect any issues relating to House Bill 733 (80th Regular Session), which addressed the sale of certain commercial heavy trucks.
[160] *Discussion of Regulation of Auto Financing: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Commissioner Leslie Pettijohn, the Texas Office of Consumer Credit Commissioner).
[161] *Id.* The dealer uses the Spot Delivery or Conditional Delivery agreement to avoid the terms of the originally agreed upon Installment Sales Contract.
[162] *Id*.

> period of time has elapsed since the purchase date. Often a consumer who believes that he or she has a completed agreement to purchase a motor vehicle is faced with the situation where a dealer is demanding more down payment funds or the dealer threatens to repossess the vehicle.[163]

If the consumer is unable to make a larger downpayment or agree to a higher finance charge, then the consumer may be faced with repossession of the motor vehicle. Many consumers whose vehicle is repossessed under a conditional delivery agreement find that the vehicle that was traded-in has already been sold to another person by the dealer. As a consequence of the dealer not being able to sell the retail installment contract, the consumer may lose a portion or all of the initial downpayment and the dealer may not be able to return the traded-in vehicle after the repossession of the new vehicle.[164] In retrospect many consumers realize that they did not understand the consequences of the conditional delivery agreement when they drove the new vehicle away from the dealership.

Negative Equity

The second focus of this report is the practice of negative equity.[165] Negative equity in a motor vehicle occurs when the owner of a vehicle owes more than the vehicle is actually worth, which is also called "being upside-down" in a loan.[166]

An example of the problematic nature of negative equity in a motor vehicle is when a consumer decides to purchase a new vehicle but still has an outstanding balance on this old vehicle that exceeds the value of the old vehicle. When the consumer trades-in his old vehicle for the new vehicle, the automobile dealer will often finance the negative equity of the old vehicle on the new contract for the new vehicle.[167]

The concern for lawmakers and the OCCC is how the negative equity is disclosed on the contract for the new vehicle.

> The problem occurs when rather than simply valuing the trade-in at its fair value and itemizing the payoff of the old vehicle, the dealer increases the value of the trade-in to equal the payoff amount and then increases the cash price of the new vehicle by the same amount. This distorts the true nature of the cash price of the vehicle as well as the value of the trade-in.[168]

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[163] *Id.*
[164] *Id.* Assessed costs and fees association with "temporary" use of the new vehicle will usually exhaust any down payment that the buyer has tendered.
[165] *See* TEX. FIN. CODE §348.404(b), which permits the practice of negative equity.
[166] *Discussion of Regulation of Auto Financing: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Commissioner Leslie Pettijohn, the Texas Office of Consumer Credit Commissioner).
[167] *Id.*
[168] *Id.*

While some guidance exists under federal regulation, the disclosure is not consistent, so that a consumer has accurate information.[169] If the consumer received proper disclosure about their negative equity on the new contract, then the consumer would be appropriately notified of the fair value of both the old vehicle and the new vehicle and the terms of the new contract.

Timely Payoff of Trade-Ins

The final practice to be studied by the Committee is the timely payoff of a trade-in vehicle. Currently, Chapter 348 of the Finance Code does not specifically address the issue of paying off debt on a trade-in.[170] When a consumer trades his old vehicle for a new vehicle, the debt on the old vehicle should be timely extinguished by the dealer. If the dealer fails to resolve the old debt, the consumer could face collection activity and negative credit reporting.[171]

ANALYSIS

During the 80th Legislative Session, legislation was filed to address these issues. Representative Burt Solomons authored House Bill 2534, which addressed the issue of conditional delivery.[172] Representative Brian McCall introduced House Bill 2590, which addressed the issues of negative equity and timely pay-off of trade-ins.[173] While the bills passed the House, the legislation did not pass the Senate. As a result, the authors requested these issues to be further studied as part of the Committee's interim study.

[169] *Id.*
[170] *Id.*
[171] *Id.*
[172] *See* House Bill 2534, 80th Leg. (2007). House Bill 2534 was intended to amend the Finance Code to state that a retail installment contract may not be conditioned on the subsequent sale of the contract to a holder.[172] A retail installment contract would be subject to rescission at the election of the seller in the event that the seller is unable to assign the contract to a holder because the buyer provided materially false information in negotiating the contract. In order to provide the basis for rescission under this subsection, House Bill 2534 would require that information provided by the buyer must have been materially false, and included on an application for credit, included on an odometer statement, or related to whether or not the manufacturer of the vehicle had ever been required by state law to repurchase the vehicle. Finally, House Bill 2534 would require all money paid by the buyer to the seller under the rescinded contract shall be refunded in hand to the buyer before the parties may execute a new retail installment contract for a vehicle.
[173] *See* House Bill 2590, 80th Leg. (2007). House Bill 2590 was written to clarify the definition of a "holder" as a retail seller, or assignee or transferee of a retain installment contract in the Finance Code. Under the legislation, a retail seller could have included money advanced in a retail installment contract only if it is included as an itemized charge. House Bill 2590 would require the holder to respond within a reasonable time, as determined by the commissioner, by providing the information or a reasonable means to obtain it. The holder may require the retail buyer to verify the requester's identity before responding to a request. House Bill 2590 would have required a retail seller to pay in full the outstanding balance of a vehicle traded in not later than the 20th working day after the date that the retail installment contract is signed by the retail buyer and the retail buyer receives delivery of the motor vehicle; and the retail seller receives delivery of the motor vehicle traded in and the necessary and appropriate documents to transfer title from the buyer.

Committee Hearing

On April 2, 2008, the Committee heard testimony on the practices of conditional delivery, negative equity and retirement of existing debt on vehicle trade-in.

Commissioner Leslie Pettijohn of the OCCC testified on the three issues. During fiscal year 2007, the OCCC received approximately 1,117 complaints on motor vehicle financing; as of February 2008, the OCCC received 393 complaints, which is less than prior years.[174] According to the OCCC's Agency Report, the number of compliance examinations increased over prior years, the rate of satisfactory compliance has increased moderately, but the level of compliance still remains below desired levels.

AGENCY REPORT[175]

Regulatory Activity	*FYTD – 2/08*	*FY 2007*
Number of MV Licenses & Registered Offices	7,351	6,975
Total MV complaints	393	1,117
Number of examinations	632	826
Amount of restitution ordered and paid	$950,293	$8,240,474
Percentage of examinations with satisfactory level of compliance	85.92%	80.39%
Percentage of examinations with unsatisfactory level of compliance	14.08%	19.61%

The OCCC receives approximately 60 complaints about conditional delivery contracts and the cases are "always very fact-specific, dependent upon the language of the contract and the conduct of the parties."[176]

[174] *Discussion of Regulation of Auto Financing: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Commissioner Leslie Pettijohn, the Texas Office of Consumer Credit Commissioner).

[175] *Discussion of Regulation of Auto Financing: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Commissioner Leslie Pettijohn, the Texas Office of Consumer Credit Commissioner); As of February 2008, the agency had performed a cumulative total of approximately 2700 examinations since September 2004 when enforcement began. This level of examination activity amounts to 36.7% of licensees having received an examination.

[176] *Id.*

Complaint Activity by Type[177]	*FYTD – 2/08*	*FY 2007*
1. Contract Provisions, including conditional delivery	212	628
2. Repossessions & Litigation	46	172
3. Charges and Fees	32	73

The practice of negative equity is fairly widespread, although the OCCC only receives approximately 10 complaints a year.[178] Despite misrepresentation in the transaction, most complaints do not result in monetary harm to the consumer, which make the cases difficult to handle. However, the OCCC believes complaints could be resolved with proper disclosures that accurately represent the negotiated agreement.[179]

The final issue is the failure to timely pay-off trade-ins. This is an enforcement issue for the OCCC and the agency receives approximately 10 complaints per month.[180] Because Chapter 348 of the Finance Code does not specifically address the issue of timely paying-off trade-in vehicles, this issue could be resolved legislatively.[181]

Brett Bray of TxDOT testified that the agency receives many complaints on the financing and advertising of auto dealerships.[182] TxDOT later submitted a letter addressing the concerns of the Committee.[183] In its letter, TxDOT stated that a "review of our recently closed case logs quickly revealed 20 cases that included a complaint involving a spot delivery…at least another 34 pending formal contested case proceedings include a complaint about spot delivery."[184]

Karen Phillips testified on behalf of Texas Automobile Dealers Association. The franchise dealers perform approximately 2 million transactions a year: 1.2 million new vehicles and 800,000 used vehicles.[185] The Committee questioned whether the Legislature should review the advertising rules governing automobile sales.[186] The industry is willing to work with the OCCC

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[177] *Id.*
[178] *Id.*
[179] *Id.*
[180] *Id.* The agency receives over 100 complaints per year.
[181] *Id.*
[182] *Discussion of Regulation of Auto Financing: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Brett Bray, the Texas Department of Transportation).
[183] Amadeo Saenz, *Letter to Texas House Committee on Financial Institutions*, Texas Department of Transportation, p. 1 (May 9, 2008).
[184] *Id.*
[185] *Discussion of Regulation of Auto Financing: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Karen Phillips, the Texas Automobile Dealers Association). Due to the current state of the economy, the industry anticipates vehicle sales in Texas will be down by at least 16% in 2008.
[186] Several members mentioned automobile advertisements in the Dallas/Ft.Worth metroplex and constituent complaints on misleading or false advertisements.

and the federal agencies on proposals to Regulation Z (which govern certain disclosures) and model contracts.[187]

Don Schwent testified on behalf of Enterprise Rent-A-Car on the issue of conditional delivery. The company operates seven licensed dealer locations in Texas and in 2007, sold approximately 3,000 vehicles.[188]

> Our case may be a little different, but I still think it provides a good example of why responsible conditional delivery practices can work in Texas. Our states statistics show that over 40% of our car sales are initiated by the consumer on Friday afternoon or Saturday. These are times when it meets the consumer's schedule between work and family obligations. For some people, it is their best available time to buy a car. At the same time, this is also a time when the financing element of the transaction may not be standing by ready with a financing decision. This is true whether the buyer wants to provide self-financing or asks Enterprise to send their credit information to a third party lender. In addition, these concentrated timeframes create large volumes of business during concentrated times. Having the ability to perform, conditional delivery transactions also saves the consumer from waiting in long lines while the consumer ahead of them has their credit transaction finalized. It is also true in many cases that the consumer, knowing what they want, prefers to take possession of a car on their first visit with us.[189]

The Committee asked each person testifying whether the underlying problem with the issues raised is accurate disclosures in the process. When questioned on the issue of conditional delivery, each speaker agreed that the Legislature should consider guidelines for a maximum time period to obtaining financing, in order to ensure that the expectations of each party are met. The Committee considered that if the consumer possesses the vehicle, the consumer should have a right of rescission should the financing become unavailable and the ability to retain their trade-in vehicle and down-payment fee.

On the subject of negative equity and timely pay offs of trade-in vehicles, the Committee debated whether the transaction was adequately understood by the consumer, whether the dealer met all expectations in a timely manner and what, if any, disclosures would be necessary to avoid confusion.

The Committee expressed frustration with the financing of motor vehicles sales and the misleading nature of certain advertisements for auto financing. However, regardless of disclosures in the agreement, the Committee discussed that certain responsibility rests on the consumer to understand what they sign.

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[187] *Discussion of Regulation of Auto Financing: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Karen Phillips, the Texas Automobile Dealers Association).
[188] *Discussion of Regulation of Auto Financing: Hearing Before the House Comm. on Financial Institutions*, 2007 Leg., 80th Sess. Interim (Tx. 2008) (statement of Don Schwent, Enterprise Rent-A-Car).
[189] *Id.*

FINDINGS

1. All parties in the automobile financing process should benefit from accurate disclosures that properly account for the terms of the transactions.

2. The Legislature should address the practices of conditional delivery, negative equity and timely payoff of a trade-in vehicle and update Chapter 348 of the Finance Code.