COLORADO DEPARTMENT OF REGULATORY AGENCIES
OFFICE OF POLICY AND RESEARCH

MORTGAGE BROKERS

2001 SUNRISE REVIEW

STATE OF COLORADO

DEPARTMENT OF REGULATORY AGENCIES
Office of the Executive Director
M. Michael Cooke, Executive Director

1560 Broadway
Suite 1550
Denver, Colorado 80202
V/TDD (303) 894-7880
(303) 894-7855

Bill Owens
Governor

October 15, 2001

Members of the Colorado General Assembly
c/o the Office of Legislative Legal Services
State Capitol Building
Denver, Colorado 80203

Dear Members of the General Assembly:

The Colorado Department of Regulatory Agencies has completed its evaluation of the sunrise application for regulation of mortgage brokers and is pleased to submit this written report. The report is submitted pursuant to §24-34-104.1, Colorado Revised Statutes (C.R.S.), which provides that the Department of Regulatory Agencies shall conduct an analysis and evaluation of proposed regulation to determine whether the public needs, and would benefit from, the regulation.

The report discusses the question of whether there is a need for the regulation in order to protect the public from potential harm, whether regulation would serve to mitigate the potential harm, and whether the public can be adequately protected by other means in a more cost-effective manner.

Sincerely,

M. Michael Cooke

M. Michael Cooke
Executive Director

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The Sunrise Process

Background

Colorado law, §24-34-104.1, Colorado Revised Statutes (C.R.S.), requires that individuals or groups proposing legislation to regulate any occupation or profession first submit information to the Department of Regulatory Agencies (DORA) for the purposes of a sunrise review. The intent of the law is to impose regulation on occupations and professions only when it is necessary to protect the public health, safety or welfare. DORA must evaluate the information submitted in order to prepare a report evaluating the justification for regulation based upon the criteria contained in the sunrise statute:

> (I) Whether the unregulated practice of the occupation or profession clearly harms or endangers the health, safety, or welfare of the public, and whether the potential for the harm is easily recognizable and not remote or dependent upon tenuous argument;
>
> (II) Whether the public needs, and can reasonably be expected to benefit from, an assurance of initial and continuing professional or occupational competence;
>
> (III) Whether the public can be adequately protected by other means in a more cost-effective manner.

Any professional or occupational group or organization, any individual, or any other interested party may submit an application proposing the regulation of an unregulated occupation or profession. Applications must be accompanied by supporting signatures and must include a description of the proposed regulation and justification for such regulation. Applications received by July 1 must have a review competed by DORA by October 15 of the year following the year of submission.

Methodology

The sunrise review process included review of the sunrise application, a comprehensive review and comparison of other states' regulation and a review of literature. We interviewed numerous constituencies including state regulators in the real estate and financial industries, regulators in other states and various consumer representatives.

Proposal for Regulation

The Colorado Association of Mortgage Brokers (CAMB) submitted a sunrise application to the Department of Regulatory Agencies (DORA) for review in accordance with the provisions of §24-34-104.1, Colorado Revised Statutes (C.R.S.). The application identifies licensure as the appropriate level of regulation to protect the public. The applicant does not specify where the program should be administratively located. The application indicates that there are no recognized minimum standards for entry into the profession and no standardized evaluation of professional competency, such as a nationally recognized examination.

A previous sunrise application for regulation was submitted in 1993 by the Colorado Association of Mortgage Brokers (CAMB). The 1993 sunrise review recommended that the profession of mortgage broker be regulated in Colorado. Legislation was introduced to implement new regulation for this profession during the 1994 legislative session. The bill was not passed by the General Assembly.

Profile of the Profession

According to the applicant, “mortgage broker” is a generic term used to describe a variety of occupations relating to the mortgage lending industry. Also included in the application for regulation are mortgage originators, mortgage lenders, mortgage bankers, loan correspondents, loan finders, loan officers, independent mortgage loan processors, and non-depository lenders. The common trait in all of these titles is that the individual qualifies applicants for a mortgage loan and arranges for financing. For purposes of this review the term mortgage broker is used to identify individuals who do not lend their own funds, are not employed by the entity lending the funds, and do not have direct control over the funds.

There is a subtle but important distinction between a mortgage broker and a mortgage lender. However, in practice, the activities performed by the two entities are virtually the same from the borrower’s perspective.

A broker uses external funds in the loan process. A broker obtains application information from a prospective borrower and attempts to match the borrower with a lender who is willing to make a loan based on the borrower's qualifications. Once the loan is closed, the lending institution is responsible for servicing the loan. However, many of the loans arranged by brokers are sold by the lending institutions, usually through one of the government-backed agencies operating on the secondary mortgage market. The secondary mortgage market is where individual mortgages with similar features are consolidated, or bundled, into a mortgage backed security and sold on the equity market as a share of stock by quasi government entities such as the Federal National Mortgage Association (Fannie Mae).

Mortgage lenders use their own funds to close loans. A mortgage lender employs loan originators, loan closers, and persons using other titles who perform functions similar to a mortgage broker as far as the borrower is concerned. These individuals obtain application information from the borrower in order to close a mortgage loan. The difference is that in most cases, the lender is using internal funds of the lender to close the loan. Like loans closed by independent brokers, loans made by mortgage lenders are generally bundled and sold on the secondary market.

Mortgage brokers service an important component of the economy. Table 1 shows the growth in home sales nationally and the average prices of homes for five years ending with 1999.

Table 1

Housing Activity

1995-1999

Year	Number of New Home Sales	Number of Existing Home Sales	Average Price Per New Home	Average Price Per Existing Home
1995	665,000	3,886,000	$157,600	$135,200
1996	758,000	4,197,000	$165,700	$141,400
1997	805,000	4,382,000	$174,400	$149,900
1998	885,000	4,970,000	$180,700	$158,400
1999	906,000	5,197,000	$194,000	$167,600

Source: Mortgage Bankers Association of America

A 1998 report by the Specialized Licensing Task Force to the Colorado Real Estate Commission estimated home sales in Colorado at 72,000 per year. It is estimated approximately 50% of these sales are financed through the services of a mortgage broker. These figures only give a hint as to the size of the mortgage industry. In addition to home sales, mortgage brokers are involved in transactions for home equity loans, second mortgages, and refinancing of existing mortgages. In fact, one of the largest areas of concern is in the refinance area. When interest rates drop, there is an increase in the number of applications for refinancing. According to the Colorado Office of the Attorney General, in the period immediately following an interest rate drop, complaints about mortgage brokers increase. Most of these complaints involve claims that a broker failed to meet commitments for a specific closing date.

The Mortgage Process

The role of the mortgage broker is to match a borrower with a lender to facilitate the loan transaction. To accomplish this role, the broker meets with the prospective borrower and gathers personal and financial information. This information is reviewed and the broker matches the profile generated against financial sources available to the individual broker. The broker will then discuss financing options with the borrower. On behalf of the lender, the broker must obtain a credit report, verify employment or income, and arrange for an appraisal of the property by a qualified appraiser. Once the broker obtains all of the required information, the loan package is submitted to the underwriting agent of the lender for approval. If approved, a real estate closing is arranged. Closings are usually conducted in the offices of a financial institution or a title company. After closing, original financial documents are forwarded to the lender and deed of trust documents are filed with the appropriate county clerk.

Most of the loans will be sold on the secondary market. For a loan to be eligible to be sold on the secondary market, it must meet the criteria established by the entities purchasing the loan. Generally speaking, the criteria are based on the credit worthiness of the borrower, type of property, the size of the loan, the loan to value (ratio of the amount of the loan to the appraised value of the property securing the loan), the term of the loan, and the interest rate. Loans that qualify to be sold on the secondary market are considered “conforming loans.”

Loans that are not eligible for sale under most circumstances on the secondary market are known as nonconforming loans. Loans may be considered nonconforming for several reasons: the size of the loan, the term of the loan, or the credit status of the borrower.

There are a number of fees collected at the closing. Broker fees may be paid by the borrower, the lender, or, most commonly, a combination of both. The borrower is usually required to pay for all third party fees in association with the loan process. These include credit checks, appraisals, document filing fees, courier fees, closing fees, and surveys to name a few. These fees are fairly standardized in the mortgage lending industry and are common in loans facilitated by brokers as well as those originated by financial institutions and mortgage lenders.

Loan origination fees, broker fees, discount points, and yield to spread fees vary greatly and depend on the type and amount of the loan. A broker fee is a clearly stated commission to the broker and is found only on broker-facilitated loans. An origination fee is similar to an application fee and is found on both broker and financial institution loans. Origination fees range from zero to five percent and also represent direct compensation to either the broker or financial institution.

When a broker facilitates a loan that trades reduced fees (points) for a higher interest rate, the broker generally receives a commission from the lender. This difference is reported to the borrower as a Yield Spread Premium. Borrowers sometimes have the option of paying discount points on various types of loans to obtain a lower interest rate. Discount points are figured into the Yield Spread Premium reported by brokers. Some of the fees charged for the loan are considered prepaid interest and are added into the total interest paid on the loan to calculate the Annual Percentage Rate (APR) for the loan.

Some consumer protections are built into the process. As an example, federally guaranteed loans, such as FHA and VA, regulate some fees. These programs specify a flat amount for certain fees and limit the loan origination fee to one percent of the loan amount. There are no federal or state limitations on fees for conventional or private loans. In addition, some brokers may charge additional fees such as processing or application fees. Additional fees are more common on subprime loans (a loan with a higher than market interest rate) generally marketed to individuals with no credit or poor credit histories.

Good faith estimates and other disclosures at the time of loan application are also intended to protect consumers. However, if consumers do not understand that some fees are negotiable they may not shop around, and may pay more for brokerage services then necessary. In fact, this is one of the areas of public harm identified by the applicant. The Federal Real Estate Settlement and Procedures Act (RESPA) requires an estimate, but there is no requirement for additional disclosure if there is a change to the estimate

The good faith estimate can be off by a substantial amount, and the consumer will not know about it until the closing. A major change of fees or the interest rate can have a significant negative impact on the borrower. Of course, the borrower does not have to take the offered loan at closing; however, failure to close may result in the loss of earnest money paid out in a purchase situation. In all mortgage loan transactions, whether a purchase, refinance, or home equity loan, fees paid by potential borrowers are non-refundable.

Generally speaking, mortgage brokers act as intermediaries between the actual lender and the borrower in a mortgage transaction. Brokers may work with a few specific lenders with whom the broker has developed working relationships or they may shop a borrower's application around to a number of lenders. A mortgage broker can work in a variety of settings from large businesses employing hundreds of brokers to small one-person operations. Brokers can collect fees from either the prospective borrower for finding a loan or from the lender for referring an applicant. In most cases, the broker will receive some portion of the fees from the borrower and the lender. These fees are disclosed to the borrower.

Associations

There are several professional/trade organizations for mortgage brokers with operations in Colorado. The Colorado Mortgage Lenders Association (CMLA) and the Colorado Association of Mortgage Brokers (CAMB) are the largest organizations that have members who would fall under the definition of mortgage broker.

CAMB submitted the application for regulation and the organization's membership supports regulation of the industry. Other professional organizations contacted for this review varied in their support of the introduction of a new regulatory program for this profession. Financial institutions generally believe there is enough regulation at the institutional level for their employees. However, they also recognize that non-depository lenders are not subject to the same degree of oversight. In some states, employees of regulated financial institutions are exempt from licensure or registration as mortgage brokers.

According to the National Association of Mortgage Brokers (NAMB), there are approximately 30,000 mortgage broker operations in the United States employing an estimated 200,000 brokers and support staff. These operations range in size from small one-person businesses to large operations with offices in several states. NAMB estimates that mortgage brokers are responsible for originating over 50 percent of the residential home loans closed in the United States.

It is not known how many mortgage brokers are doing business in Colorado at this time. According to the applicant, the Colorado Association of Mortgage Brokers has 350 member companies and the Colorado Mortgage Lenders Association has 340 member companies. It is likely that that there is some overlap in membership between the two organizations, thereby reducing the actual number of member brokers in Colorado. Some members may be larger entities with several brokers on staff, which would increase the number of individual brokers.

As with all professional organizations, there are undoubtedly some brokers who do not belong to either organization. Also, depending on how broadly the definition of broker is interpreted, loan officers and other employees at banks, savings and loans, and credit unions may also be classified as mortgage brokers. These entities are already regulated at the state and federal level.

Education

The applicants report that education is available through various trade associations. These educational programs often lead to a private credential such as Colorado Certified Mortgage Broker, Certified Mortgage Consultant, or Certified Mortgage Banker among others. There is no single definable educational program that qualifies one to practice as a mortgage broker.

Examination

The sunrise application states that there is no single examination to measure qualification. One possible examination is that used by the National Association of Mortgage Brokers related to that association's private credentials of Certified Mortgage Consultant and Certified Residential Mortgage Specialist. The applicability of any examination would depend upon a legislative scope of practice among other factors.

Summary of Current Regulation

The Colorado Regulatory Environment

Although not directly regulated by any federal or state agency, the activities of mortgage brokers fall under the provisions of several federal and state laws. Those opposed to regulation contend these laws provide an adequate framework to protect the public. Some advocates for regulation point out that these laws create problems due to their overlapping provisions and the gaps in enforcement inherent in a regulatory structure without a single entity responsible for enforcement.

There are several Colorado statutes that directly or indirectly impact the mortgage business. A brief summary of the various laws that pertain to this occupation follows:

Colorado law contains specific references to mortgage brokers in §38-40-101 et seq., C.R.S., which is included in this report as Appendix B. This statute defines a mortgage broker in §38-40-101 (6), C.R.S. as:

> As used in this section, unless the context otherwise requires, "mortgage broker" means a person, firm, partnership, association, or corporation, other than a bank, trust company savings and loan association, credit union, supervised lender as defined in section 5-1-301 (46), C.R.S., insurance company, federal housing administration approved mortgagee, land mortgagee, or farm loan association or duly appointed loan correspondents, acting through officers, partners, or regular salaried employees for any such entity, that engages in negotiating or offering or attempting to negotiate for a borrower, and for commission, money, or other thing of value, a loan to be consummated and funded by someone other than the one acting for the borrower.

The statute requires that fees be deposited in an escrow account, and requires brokers to make good faith estimates of fees charged by the lenders. It also contains provisions for the servicing of mortgages. Violations of the statute include punitive damages of $1,000 in addition to the actual damages caused by the violation and attorney fees.

In addition to the above, several statutes are applicable to mortgage broker practice. Brokers, like all lenders, must comply with criminal statutes related to theft, usury, and extortion. In addition, there are specific provisions in §11-38-101 et seq., C.R.S. which relate to reverse mortgages.

A loan finder is defined in §18-15-109, C.R.S., which contains specific provisions regarding fees. However, mortgage brokers are exempt from some sections of this statute.

All persons engaged in lending are required to comply with the provisions of the Uniform Consumer Credit Code (UCCC), contained in §5-1-101, et seq., C.R.S. The UCCC contains requirements for disclosures, restrictions on interest rates, and acceptable loan practices.

Some mortgage brokers are also subject to the provisions of the Colorado Securities Act, which requires a securities license. However, the securities act is designed to protect investors not borrowers. A security is defined by §11-51-201(17)), C.R.S. as:

> (17) "Security" means any note; stock; treasury stock; bond; debenture; evidence of indebtedness . . .

A mortgage falls under the definition of a security when a mortgage broker sells a mortgage to a private investor. There are approximately 50 mortgage brokers who are licensed by the Colorado Division of Securities as security brokers. These mortgage brokers specialize in selling mortgages to private investors. However, in most situations, brokers are acting as intermediaries for regulated financial institutions and therefore the transactions are exempt from regulation under the securities act.

Federal Regulation

Mortgage brokers are subject to numerous federal laws. This section provides an overview of federal significant federal requirements.

Equal Credit Opportunity Act (ECOA)

Prohibits discrimination against loan applicants based on race, color, religion, national origin, sex, marital status or age. Regulation B promulgated under ECOA establishes specific application requirements.

Fair Credit Reporting Act (FCRA)

Requirements for credit reporting and credit worthiness of applicants.

Fair Housing Act

Prohibits discrimination in the sale, rental, and financing of any residential housing.

Fair Lending Act

Prohibits discrimination in lending practices.

Home Mortgage Disclosure Act (HMDA)

Requires that specific information be made available to the public when mortgages are sold on the secondary market.

Home Ownership and Equity Protection Act (HOEPA)

Requires specific disclosures on loans with annual percentage rates (APR) more than 10 percentage points above the rates on United States Treasury Securities of comparable maturity.

Real Estate Settlement Procedures Act (RESPA)

Requires the disclosure of fees and costs involved when closing home mortgages (good faith estimates). Prohibits abusive practices.

Truth in Lending Act (TILA)

Requires disclosure of loan terms and percentage rates in a form that is intended to make it easier for consumers to compare loans.

Regulation in Other States

Mortgage brokers are regulated in most states although the level of regulation varies significantly. Some states require a combination of education and experience before qualifying for licensure as a broker. Other states allow any individual who posts a bond to register or obtain a license as a broker. Some states license individual brokers; others only license the broker business. Some states have enacted practice acts that restrict the activities of a broker without actually regulating individual brokers. Table 2 summarizes information about regulatory programs in other states.

Table 2

State Regulatory Programs

Key: N=No regulation L=Licensure R=Registration N=No Regulation

State	Type	Agency	Education	Experience	Exam	Bond	Net Worth Requirement	Criminal Background Check	Other
AL	N	Division of Banking	Licenses businesses not individuals						
AK	N								
AR	L	Securities Department				✔	✔	✔	
AZ	L	Banking Department	✔	✔	✔	✔		✔	
CA	L	Financial Services Division or Department of Real Estate				✔	✔	✔	
CO	N								
CT	L	Dept. of Banking	Licenses businesses not individuals						
DC	L	Banking and Financial Division				✔	✔		
DE	L	Banking Commissioner				✔			Annual audit
FL	L	Department of Banking and Finance	✔		✔			✔	Must be an associate or employee of a licensed brokerage business

State	Type	Agency	Education	Experience	Exam	Bond	Net Worth Requirement	Criminal Background Check	Other
GA	L	Banking and Finance	✔ or	✔		✔ or	✔	✔	
HI	L	Division of Financial Institutions		✔		✔	✔		
ID	N	Department of Finance	Licenses businesses not individuals						
IL	L	Office of Banks and Real Estate		✔			✔	✔	
IN	R	Secretary of State	✔						
IA	L	Iowa Division of Banking				✔		✔	
KS	L	Office of the State Bank Commissioner					✔	✔	
KY	L	Department of Financial Institutions	✔			✔			
LA	L	Office of Financial Institutions				✔		✔	Mandatory continuing education
MA	L	Division of Banks		✔		✔	✔		Mandatory continuing education
MD	L	Department of Licensing/Regulation				✔		✔	
ME	L	Department of Professional and Financial Regulation				✔	✔	✔	
MN	L	Department of Commerce		✔					

State	Type	Agency	Education	Experience	Exam	Bond	Net Worth Requirement	Criminal Background Check	Other
MI	L	Office of Financial and Insurance Services		✔		✔	✔	✔	
MO	L	Division of Finance.	Licenses businesses not individuals						
MS	R	Department of Banking and Consumer Finance	Licenses businesses – Registers individuals						
MT	N								
NE	L	Nebraska Department of Banking and Finance				✔		✔	
NM	R	Regulation & Licensing Department		✔		✔			
NY	L	Banking Department		✔				✔	Real estate broker and attorneys exempt
NH	L	Banking Department				✔	✔	✔	
NJ	L	Department of Banking and Insurance			✔	✔			Good moral character, physical location
NV	L	Department of Business & Industry		✔				✔	
NC	R	Commissioner of Banks				✔	✔		
ND	L	Department of Banking and Financial					✔		Character and fitness

State	Type	Agency	Education	Experience	Exam	Bond	Net Worth Requirement	Criminal Background Check	Other
OH	L	Department of Commerce		✔		✔		✔	
OK	L	Department of Consumer Credit		✔			✔		
OR	N	Department of Consumer and Business Services	Licenses businesses not individuals						
PA	L	Department of Banking				✔			Physical location, two employees and must be HUD approved
RI	L	Department of Business Regulation Division of Banking				✔	✔		
SC	L	Department of Consumer Affairs	✔ or	✔	✔	✔			
SD	L	Division of Banking						✔	Physical location or registered agent
TN	R	Department of Financial Institutions				✔	✔	✔	Good character, physical location and must be approved by FNMA, VA or FHA
TX	L	Texas Savings and Loan Department (First Mortgages)	✔	✔			✔	✔	Attorneys and real estate brokers exempt
	L	Texas Consumer Credit Commission (Second Mortgages)		✔			✔	✔	Physical location

State	Type	Agency	Education	Experience	Exam	Bond	Net Worth Requirement	Criminal Background Check	Other
UT	R	Department of Financial Institutions				✔		✔	
VA	L	Bureau of Financial Institutions				✔		✔	Physical location
VT	L	Department of Banking, Insurance,		✔		✔			Good character
WA	L	Department of Financial Institutions	✔ or	✔	✔				
WV	L	Division of Banking				✔	✔	✔	
WI	L	Department. of Financial Institutions				✔ or	✔	✔	Physical location, annual audit
WY	N								

Analysis and Recommendations

In most real estate transactions there is a potential for either the borrower/buyer or the seller/lender to suffer a loss. The risk to the borrower is in not obtaining the best terms possible thereby paying more than necessary for the loan. The extension of credit by a lender exposes the lender to the loss of capital. To compensate for this potential loss, lenders adjust the rate of interest they charge for a loan, based partly on the level of risk involved with the potential borrower. In the case of a mortgage loan, the lender faces the additional risk of market uncertainty.

However, lenders are sophisticated investors, able to evaluate the risk involved in the transaction and adjust interest rates to compensate. There are also government agencies responsible for oversight when the lending entity is a depository institution. This oversight is intended to protect the lender's depositors by regulating risk to the depositors' funds.

Interest rates fluctuate over time. All investors desire to maximize their return on investment. Mortgage loans are usually for long time horizons, typically 15 or 30 years. Most mortgage loans have fixed interest rates, locking the investor into an established rate of return, although variable rate loans have become more popular in recent years.

Residential mortgage loans are relatively safe loans for investors. That is, since they are secured by real property, they are lower risk loans for investors. However, they are not completely without risk. Borrowers can default requiring the lender to foreclose on the property, which involves expense for the lender. Sometimes borrowers file bankruptcy, causing a loss for the lender. When interest rates decline, borrowers frequently refinance loans at a lower rate, reducing the return the lender had projected.

The contention of the applicant is that without state oversight, borrowers are unreasonably at risk from deceptive and fraudulent actions by brokers. Advocates for regulation maintain a regulatory program for brokers will eliminate harmful lending practices in the home loan industry. Instances of potential harm submitted by the applicant range from payment of a few hundred dollars in unnecessary or excessive fees to the loss of the family home.

Fees

Federally backed loan programs such as FHA and VA limit the amount a lender or broker can charge for some fees. However, conventional and subprime loans are not subject to any limits. The federal Real Estate Settlement Procedures Act (RESPA) requires disclosure of fees, so consumers are aware of what they are being charged. If consumers are inclined, they may compare fees with different brokers. However, this is sometimes difficult when comparing different loan programs.

A related issue concerns brokers who charge upfront fees and then are unable to close the loan. This can happen when a broker takes an application fee from a potential borrower knowing it is unlikely that the applicant will qualify for a loan. Advocates for regulation allege that there are scam brokers who set up shop and collect applications and fees with no intention of trying to find a lender for the applicant.

However, it is important to remember that brokers collect the majority of their commission and fees when loans actually close. While it is possible for brokers to generate a few hundred dollars in application fees per potential borrower, it is in their best interest to find lenders, close loans, and thereby earn up to several thousand dollars on each completed deal.

Bait and Switch

It is alleged by the applicant that brokers advertise low interest rate loans and then quote the applicant a higher interest rate after the application is completed, indicating they do not qualify for the low rate for some reason. It is legal for a broker to advertise "rates as low as 6% available" as long as the broker has a lender willing to lend at that rate even if the broker never actually closes a loan at that rate.

When a broker makes a good faith estimate for a potential borrower, all of the fees and payments quoted on the estimate are based on the loan amount and interest rate discussed during the application phase of the loan process. The applicant may not find out until the day of the closing that the interest rate, fees, and loan payments have increased, sometimes substantially. Of course, the borrower is not obligated to close the loan. However, if the borrower refuses the loan, the borrower forfeits any upfront fees already paid.

The loss of upfront fees may range from a few hundred to several thousand dollars. However, there are other consequences. In a real estate purchase agreement, there is usually a specified closing date. If the purchaser fails to arrive at the closing with certified funds, the transaction is canceled. This results in the forfeiture of any earnest money deposited to hold the property, usually one to three percent of the purchase price, and the home will be placed back on the market to be sold to the next potential buyer.

Related to this scenario is the revocation of a pre-approval. In this case, prospective home buyers search for a home after providing a broker with financial information to obtain tentative approval for a loan of a specific amount and term. In a scam, after the earnest money is deposited on a home, the broker informs the consumer that the pre-approval has been withdrawn for some reason. The broker then offers to obtain financing for different, less favorable, terms.

In many cases, potential borrowers are selling their current house to move into another house. If a borrower has already closed on the sale of their current home, the borrower may feel compelled to take the higher interest rate loan just to ensure that his or her family has a place to live. Advocates for regulation have offered case studies that document instances of this occurrence.

Loan Flipping

Loan flipping is a general term for repeatedly refinancing a mortgage loan in a short period of time. Each refinance is subject to fees based on the amount of the loan. Each loan is generally larger than the previous loan, reducing the equity in the home and increasing costs to the consumer.

Subprime Loans

Borrowers with poor credit ratings generally do not qualify for many government backed and conventional loan programs. This does not mean these individuals will not qualify for a home loan. It means that they will be seeking financing from lenders who specialize in what are known as subprime loans. Because there are greater risks involved in lending to borrowers with lower credit, subprime loans carry a higher interest rate than conventional loans. This higher interest rate translates into higher payments for the borrower, and in time, a higher cost for the property.

Small differences in an interest rate will make a substantial difference in the amount paid for a piece of property. On a monthly basis, the difference may not seem like much. However, over the life of a loan, the amount is staggering. Table 3 demonstrates the approximate difference interest rate changes can make on a typical $150,000 home loan with a 30-year term.

Table 3

Effects of Interest Rate Differences on Loan Payments

Loan Amount	Interest Rate	Payment	Monthly Difference	Term Difference
$150,000	8.0%	$1,100	N/A	N/A
$150,000	8.5%	$1,153	$53	$19,080
$150,000	10.0%	$1,316	$216	$77,760

Lenders providing subprime loans provide a valuable service to a certain market niche, those consumers who do not qualify for conventional lending. However, when individuals with good credit ratings receive a subprime loan, or when a loan has significant prepayment penalties, it can cause financial harm the consumer. According to the American Association of Retired Persons (AARP) 60 percent of all subprime loans nationally are made to people who would qualify for prime loans.

Similar to boiler room telemarketing fraud, unscrupulous brokers target people who have recently refinanced with a subprime lender to refinance again. These brokers convince the borrower that they can get them a better interest rate and some cash back. Again, it must be stressed that not all subprime loans with cash back are harmful.

In February and March of 2001, the Denver Post printed a series of articles related to home foreclosures and the events leading up to foreclosure. The articles concentrated on the questionable practices of some foreclosure investors who purchase property in foreclosure with the intention of reselling the property at a profit. The articles pointed out several problems with the legal process associated with foreclosures. However, what caught the attention of some members of the public and the General Assembly was the fact that in some cases, individuals who lost their homes to foreclosure had been victims of questionable lending practices.

In one example, Mrs. P, an 81 year old widow who had lived in a home for 42 years, wanted to remodel her home. When the contractor she hired went bankrupt before completing the project, she refinanced her home to pay a second contractor to complete the work. Her refinance was done through a subprime lender with an adjustable rate mortgage.

She was convinced by various brokers to refinance her loan an additional three times over the next four years. Each time she refinanced, the loan balance increased. By the end of 1999, she had an outstanding mortgage balance of $117,000 and monthly payments of $911, not including taxes and insurance. This on a house she originally purchased for $11,000 and was presumably paid for when she first attempted to remodel. This is a classic case of loan flipping.

Fraudulent Applications

According to the applicant one tactic used by unscrupulous brokers that harms both consumers and investors is falsifying information on loan applications. Usually this falsification takes the form of overstating income and/or assets, or understating liabilities.

There is harm to the consumer when a borrower finds that he/she cannot afford to make payments at the level required by the loan agreement. The borrower can fall behind in payments, default on the loan, and face foreclosure on the home. If the application had been accurately submitted, chances are that the borrower would have been denied the loan in the first place or not have increased the loan balance by taking cash out. On a new home purchase, it is likely that the prospective borrower would have sought a more affordable property to purchase.

There are adequate laws to protect the public from fraudulent loan applications. Falsifying a loan application is a criminal offense. There has been at least one broker prosecuted in the Denver area for over 100 charges related to falsifying loan applications. This individual recently settled in federal court with a plea bargain arrangement.

The applicant has submitted information supporting an argument that there are potentially harmful lending practices existing in the home loan market. Although not all of these practices are illegal, many may be considered unethical. Areas of the country with increasing home values are susceptible to harmful practices. The problem is compounded when interest rates decline. Among the practices decried by consumer advocates are: marketing higher than market rate loans in low income neighborhoods, convincing elderly homeowners to refinance homes that have a low mortgage balance, locking consumers into high interest rate loans with substantial prepayment penalties, convincing borrowers to borrow more than they can afford by utilizing creative loan packages including negative amortization or large balloon payments, loan flipping, and lending without regard for the ability to repay.

These harmful practices are not limited to mortgage brokers. Home improvement contractors, finance companies, debt consolidators, and car dealers sometimes have lending practices that could harm consumers. The applicant and supporters for regulation supplied several examples lending practices that harmed consumers.

When a consumer is subjected to a harmful lending practice the equity available in their home is reduced and monthly payments increase. In fact, given that some lenders will make loans at an amount above the market value of the home, it is conceivable that a targeted individual will end up with a mortgage greater than the worth of the home and no means to make the payments.

Documentable Harm

One of the requirements of the sunrise process is documentation of public harm. In the absence of a regulatory program, there is seldom a centralized collection point for data regarding the subject of proposed regulation. In conducting research for this review, data was collected from several sources including the Mortgage Lenders Association complaint files, the Consumer Protection and Uniform Commercial Credit Code (UCCC) Divisions of the Attorney General's Office, the Better Business Bureau, the Colorado Division of Banking complaint files, and surveys of local district attorneys. Information was also sought from the regional HUD office.

The Colorado Attorney General's Office has two separate divisions that receive complaints related to mortgage brokers. The Uniform Commercial Credit Code (UCCC) regulates second mortgages that exceed the 12% per year annual percentage rate established in statute. The UCCC has no jurisdiction over first mortgages or second mortgages under the threshold. The UCCC reports it receives approximately 250 telephone complaints per year related to mortgage brokers, mostly for failure to close at the time promised. Since the UCCC has no jurisdiction, it refers callers to other agencies or organizations such as the Mortgage Lenders Association that may help.

The Consumer Protection Division (CPD) of the Attorney General's Office is charged with enforcement of the Consumer Protection Act in Colorado. The CPD reports it receives several written complaints each year related to mortgage brokers. Most complaints are dismissed for lack of jurisdiction or lack of evidence that a Colorado law has been violated. Occasionally, the division initiates an investigation that results in legal action. Table 4 illustrates the complaints received by the Consumer Protection Division.

Table 4

Consumer Protection Division - Complaint Information

Year	# Complaints	# Investigations	# Actions Taken
1996	27	0	0
1997	30	3	3
1998	18	2	0
1999	28	0	0
2000	23	0	1
2001*	14	0	0
Total	140	5	4

*Partial year data

Inquiries were made to each district attorney's office in Colorado regarding mortgage broker complaints. Most district attorneys responded that regretfully they did not track complaints or investigations by profession and were unable to provide statistical data. However three districts, the Fourth (Colorado Springs), Twentieth (Boulder/Longmont), and the Twenty First (Grand Junction/Mesa) reported 67 cases investigated over the past three years with six resulting in criminal charges being filed.

There are five Better Business Bureaus (BBB) serving Colorado; the BBB of the Pike's Peak Region, Denver Area BBB, BBB of the Mountain States (Ft. Collins), BBB Four Corners (Farmington NM), and the BBB of Southern Colorado (Pueblo). Companies that are members of a BBB agree to work through the BBB to resolve consumer complaints. Each of these private organizations was contacted for complaint data related to mortgage brokers for the past two years. They reported 53 complaints that were not resolved through their efforts.

The Division of Banking in the Department of Regulatory Agencies regulates state chartered commercial banks. While most banks are involved in mortgage lending, the Division of Banking does not regulate mortgage brokers or mortgage lenders. The Division of Banking receives frequent calls related to entities or individuals they do not regulate. While the inquiries are tracked and reported, they are not separated as to mortgage broker, mortgage banker, or other mortgage non regulated lending entity. Table 6 details inquiries received by the Division of Banking for the past three years.

Table 6

Division Of Banking – Non Regulated Mortgage Inquiries

Fiscal Year	Number of Inquiries
1998/99	892
1999/00	806
2000/01*	500
TOTAL	2,198

* Partial year data due to data collection problems with the tracking system.

The Colorado Mortgage Lenders Association (CMLA) is a private trade association representing various mortgage lending entities. The CMLA has established a code of ethics for member entities and operates a Consumer Help Line to provide consumers with an avenue to obtain information regarding mortgage loans and lenders. The help line also provides a mechanism for consumers to file complaints about the practices of mortgage lenders.

Help line complaints are referred to volunteer member representatives for response, and attempts are made by the CMLA to resolve all complaints by establishing communication between the parties, whether the company involved is a member of CMLA or not. When a resolution cannot be reached, the complaint is referred to the Chair of the Ethics Committee of the CMLA for review. CMLA reports that in 1999, 44 member and 48 non-member firms had complaints referred to the Ethics Chair. In 2000, 14 member and 39 nonmember complaints were referred to the Chair.

Advocates for regulation supplied other instances of public harm available as case studies. These instances involve both criminal and civil cases that have been adjudicated through the court system. However, there is no method to quantify these cases. Individual attorneys contacted for this review cited specific cases incidental to their personal practice. Some of these cases may also be included in the complaint statistics from the various organizations reported earlier.

Some district attorneys allege that although some practices of unethical mortgage brokers could be considered violations of current statutes, it is difficult to obtain a conviction unless a pattern of abuse can be documented. Civil litigation attorneys allege that because the amount of damages incurred by most consumers is relatively small, it is frequently not cost effective for a consumer to seek relief through the courts. Some attorneys have suggested implementing a treble damages provision into the Colorado Consumer Protection Act to facilitate legal action by consumers.

Public Harm

Sunrise reviews are required to evaluate regulatory proposals against the sunrise criteria.

The first sunrise criterion asks:

Whether the unregulated practice of the occupation or profession clearly harms or endangers the health, safety, or welfare of the public, and whether the potential for the harm is easily recognizable and not remote or dependent upon tenuous argument.

The applicant maintains that mortgage brokers should be licensed in order to protect the public. Licensing generally requires an establishment of minimum competency through education and/or experience, an examination process, and, in some cases, a demonstration of minimum financial resources.

Licensing places a barrier to entry into a profession that may cause a constriction in the supply of the professional services and an increase in the cost of this service. This increase in cost is born by the consumer in return for the protection offered by the regulatory scheme. When licensed professionals fail to adhere to practice standards established by the regulatory program, they are subject to sanctions up to and including restrictions on their practice of the profession or revocation of their privileges to practice the profession.

Unethical practices of mortgage brokers clearly endanger the public welfare by placing consumers at risk for not only paying excessive fees and interest but also losing their homes. Some of the practices that result in public harm, such as falsifying application information, are criminal activities and are subject to prosecution under those codes. While some of the other practices of unethical brokers could potentially harm the public, it must be pointed out that they are not illegal. Unless harmful practices such as loan flipping are somehow restricted, licensing mortgage brokers will not protect the public from most of the potential problems discussed in this report.

It is clear that some lending practices have the potential to harm the public. Case studies and anecdotal information reveal that uninformed consumers can be victimized into paying excessive fees for loans, at higher interest rates than can be justified and be subject to unnecessarily restrictive prepayment penalties. This problem has been studied by both private and governmental entities, such as AARP and HUD; however, there is little documentation available as to the extent of the problem.

Need for Regulation

The second sunrise criterion asks:

Whether the public needs, and can reasonably be expected to benefit from, an assurance of initial and continuing professional or occupational competence.

The applicant has identified licensure as the appropriate level of regulation to protect the public. Licensing is a regulatory structure which generally includes direct oversight by a regulatory authority with the ability to promulgate regulations and administer discipline and a minimum competency demonstration for entry to the profession. This report concludes that minimum competency is not an issue with mortgage brokers. Actual harm to the public is caused by specific practices of individuals soliciting loans. However, there is no evidence that the harm is caused by a lack of education or experience in the mortgage industry. In fact, the evidence indicates that the lending practices are not limited to mortgage brokers.

The evidence submitted and considered by this review does not establish the need for an initial level of professional competency for entry into the profession. A review of requirements nationally found a wide range of licensing standards. Some states require minimum education, others experience, some a combination of education and experience. The majority appear to rely on the ability to obtain a surety bond as the sole criteria for licensure.

Technical knowledge of the industry does not appear to be an issue in the cases presented that involved consumer harm. In fact, the most egregious cases seemed to involve individuals experienced in the home loan industry who appeared to be very aware of the legal requirements loans.

Since the majority of states have regulatory programs for mortgage brokers, it would seem logical that states without regulatory programs have more problems than those that regulate mortgage brokers. However, the evidence does not support this view.

The HUD report on predatory lending focused on a few cities with disproportionate problems associated with undesirable lending practices. The two cities the HUD report cited as having significant problems were Atlanta and Baltimore. All of the states that hosted HUD forums on the issue (California, Georgia, Illinois, Maryland, and New York) license mortgage brokers yet reported problems with predatory lending and foreclosures.

Harmful lending practices are not reserved for the professionally incompetent broker. In fact, it may be argued those committing the most egregious actions have highly developed skills.

Based on the evidence presented by the applicant and analysis of the practices in other states it is concluded that there is a low expectation that the public would benefit from a regulatory program that requires professional competency standards for this profession.

Alternatives to Regulation

The third sunrise criterion asks:

Whether the public can be adequately protected by other means in a more cost-effective manner.

The harm to the public identified by the applicant for this review is not the result of the unregulated practice of mortgage brokers. Rather, the harm is from identifiable lending practices. Some individuals involved in the home loan industry knowingly use unethical and sometimes illegal practices to defraud unwitting victims out of the equity they have built up in a home, or to gouge homebuyers with excessive fees. It is likely that alternatives to licensing could provide adequate public protection without the expense and barriers to entry that a licensing program would entail. It is likely that the public could be protected by legislation addressing specific potentially harmful lending practices without the creation of a new regulatory program.

Conclusion

Recommendation - The General Assembly should take no action based on the application request for regulation of mortgage brokers.

As discussed under criterion one and two, licensing programs are designed to insure minimum competency standards for practitioners and to enforce practice standards. The consequence of a regulatory program is a reduction in the number of practitioners as a result of the barrier to entry.

It may be a necessary use of the police powers of the state to require minimum competency standards for the practice of professions such as engineering and medicine. These professions have highly specialized training and potential for physical harm to the public when practiced improperly. However, no evidence was presented that demonstrated lack of education or experience as a cause for harm to the public. Harm to the public occurred because of specific, identifiable practices of some individuals involved in home loans.

This review found that the potential for harm to Colorado consumers is of sufficient magnitude to require action by the General Assembly. However, the evidence reviewed does not indicate the necessity for a licensing program at this time. Other options represent a more measured response to the potential for harm.

Several states have enacted statutes designed to prevent harmful lending practices. The General Assembly should consider defining lending practices such as loan flipping, excessive fees and prepayment penalties, which clearly have the potential to harm consumers. These practices, which can be perpetrated by brokers, contractors, loan consolidators and lenders, should be addressed by specific legislation.