REPORT TO PUBLIC SAFETY & REGULATORY SERVICES COMMITTEE FROM CITY STAFF PREDATORY LENDING WORK TEAM

January 7, 2004

BACKGROUND

On July 16, 2003, the Public Safety & Regulatory Services Committee directed the City Coordinator to "identify a team of individuals within the City who have the expertise to work on the various [predatory lending] approaches." The three primary "approaches;" namely educational efforts, proprietary policies, and regulatory initiatives, were previously outlined and discussed in an April 17, 2003, memorandum from the City Attorney's Office (attachment 24). Following this direction, the City Coordinator's Office proposed a City staff predatory lending work team comprised of the following individuals:

- Jay Heffern/Erik Nilsson – City Attorney's Office
- Erik Takeshita/Mark Spector – Mayor's Office
- Lori Olson – City Coordinator's Office
- Alicia Scott – Communications Department
- Linda White – Civil Rights Department
- Michael Nguyen – Treasury Department
- Mark Anderson – CPED/Finance
- Bonnie Balach – Intergovernmental Relations

On August 8, 2003, after approval of the composition of the City staff team, the City Council directed staff as follows:

> Predatory Lending: Direct staff to develop comprehensive City response to issue of responsible lending that promotes consumer education and emphasizes vigorous enforcement of existing laws; staff to become acquainted with the "Don't Borrow Trouble" campaign and recommend a plan for the City to complement its efforts; and staff to promote enforcement of State and Federal laws already in force as well as identifying gaps in existing laws, and report back to Committee in three months, with comments.

In the course of fulfilling this staff direction, the staff team held ten meetings, in which it reviewed and discussed each of the three main approaches to addressing the issue of predatory lending. Using their respective areas of expertise within the City, the team also created subgroups to delve further into each of the approaches. For example, Alicia Scott (Communications), Lori Olson (City Coordinator's Office), and Linda White (Civil Rights) explored the area of consumer education.

The City staff team solicited input from non-City personnel as well. On October 8, 2003, Jacqueline Nicholas, the Community Affairs Manager for the Federal Reserve Bank of Minneapolis, spoke to the team about her involvement with the issue of predatory lending. Discussions were also conducted with the Family Housing Fund, Department of Housing officials in Chicago, and licensing personnel within the City's Regulatory Services Department.

The team then met on separate occasions with both the proponents and opponents of City action. On October 23, 2003, the staff team met with the advocate community, including Becky Gomer (ACORN), Sam Magavern (Legal Aid), Jim Bernstein (former Commerce Commissioner), and Keith Weigel (AARP). On October 29, 2003, the staff team met with the financial industry representatives, including Pat Martyn (American Financial Services Association/MN Association of Mortgage Brokers), Steve Johnson (MN Bankers Association), and Eric Ewald (Mortgage Association of MN).

Finally, three joint meetings were held between all interested parties and the City staff team on November 10th, November 21st, and December 2nd, 2003.

Following is a report on the result of these discussions, including an analysis of each of the three main approaches, as well as other options that were discussed during the course of the meetings. The staff team received a number of submissions from the meeting attendees and these documents are collected in an attached appendix.

REPORT

The topic of predatory lending encompasses a large number of extremely complicated, technical issues influenced by legal, financial, and political considerations. The composition of the staff team reflected these wide-ranging considerations and accordingly included representatives from the City's legal, financial, and political departments as well as other City departments with a potential stake in the issue. The staff team strove to "develop [a] comprehensive City response to [the] issue of responsible lending" in accordance with the City Council's staff direction; however, it became apparent that it was not possible to exhaustively address every issue associated with the topic in the limited amount of time available. Nevertheless, considerable attention was accorded the topic by both the team members and stakeholders.

The difficulty in comprehensively addressing the topic is compounded by two factors: 1) a lack of consensus on the definition of predatory lending and 2) the dearth of specific, hard data on the incidence of predatory lending in the City of Minneapolis. There is simply no overriding consensus on a standard definition of "predatory lending." Federal law does not contain a definition and state laws characterize it differently according to the prevalence of identified "abusive" practices in association with certain residential mortgage loans. Minnesota law does not contain a definition of predatory lending. However, in jurisdictions with anti-predatory lending provisions, a predatory loan is generally considered to be a "high cost" loan secured by residential real estate made under abusive circumstances. Whether a loan is deemed "predatory," therefore, depends not only on its terms, but also on the context in which it is made.

There is also a lack of hard data on the prevalence of predatory lending within the City. A report provided by ACORN entitled "The Cost of Predatory Lending in Minneapolis" includes data on subprime lending and anecdotal evidence of predatory lending cases occurring within the City (attachment 1). It must be kept in mind, however, that subprime lending does not equate with predatory lending. The ACORN report notes the distinction as follows:

> Subprime loans are intended for people who are unable to obtain a conventional prime loan at the standard bank rate. The loans have higher interest rates to compensate for the potentially greater risk that these borrowers represent. There is a legitimate place for flexible loan products for people whose credit or other circumstances will not permit them to get loans on "A" terms. Predatory lending occurs when loan terms or conditions become abusive or when borrowers who should qualify for credit on better terms are targeted instead for higher cost loans (attachment 1; p. 3).

While not all subprime lending is predatory, almost all predatory loans are subprime loans. Although it is instructive, data on subprime lending alone, therefore, does not necessarily point to the prevalence of predatory lending practices in the City. As the ACORN report recognizes, “only approximate estimates can be made of the costs that predatory loans impose on homeowners because of the limited data required to be reported and the complicated nature of individual home loans” (attachment 1; p. 9).

The lack of specific data on predatory lending may be ameliorated in the future by additional reporting requirements pursuant to the Federal Reserve Board’s Regulation C of the Home Mortgage Disclosure Act (HMDA). Effective January 1, 2004, an amendment to Regulation C will require financial institutions to report whether a loan is subject to the provisions of the Home Ownership and Equity Protection Act (HOEPA). As the principal federal law addressing predatory lending, HOEPA prohibits certain identified predatory practices in “ultra-high-cost” loans. HOEPA’s protections are triggered by loans at least eight percentage points above the yield on Treasury securities of comparable maturity for first-lien loans or with points and fees comprising at least eight percent of the loan amount. 15 U.S.C. § 1602(aa). The protections provided include additional disclosure requirements, limitations on prepayment penalties, a prohibition on higher interest rates after default, limitations on balloon payments, a prohibition on negative amortization, and certain restrictions on home improvement scams. 15 U.S.C. § 1639. The additional HMDA reporting requirements should provide better guidance in the future as to the concentration of “high cost” mortgages in various communities and population groups.

I. CONSUMER EDUCATION AND OUTREACH INITIATIVES

Many of the problems associated with predatory lending stem from the informational disadvantage faced by the borrower in a complex loan transaction. Consumer education initiatives seek to combat this informational asymmetry by informing borrowers about predatory lending practices and their rights under the law. These initiatives may entail informing the general public about the characteristics and hazards of predatory lending via print and broadcast media sources, as well as loan counseling on an individualized basis by the City and nonprofit organizations to help borrowers recognize and avoid predatory loans. By creating an informed public, the hope is that market forces will drive out predatory lending entities. There are no legal constraints on the authority of the City to undertake or support educational efforts.

A. Don’t Borrow Trouble

National consumer education initiatives include Freddie Mac’s (the Federal Home Loan Mortgage Corporation) “Don’t Borrow Trouble” campaign, which was piloted in Boston in 1999 and has expanded to over 25 other communities nationwide (attachment 2). Local campaigns are carried out by local government agencies in cooperation with a wide range of local partners, including non-profit housing providers, credit counseling agencies, fair housing associations, and industry groups. These campaigns use brochures, mailings, posters, public service announcements, transit ads, and television commercials to inform the public and provide assistance to consumers if they have already taken out a loan.

Launched on March 5, 2003, the Don’t Borrow Trouble Minnesota Campaign is a public education campaign aimed at stopping predatory lending practices in the Twin Cities seven-county metropolitan area (attachment 2). Assuming financial solvency, the campaign is currently slated to run through 2004. It is administered by the Family Housing Fund in partnership with more than 60 organizations, including representatives from government, non-profit organizations, the lending and real estate industry, and legal agencies and firms. The campaign combines education and advertising through billboards, interior bus ads, posters, brochures, radio/television commercials, and a website – www.dontborrowtroublemn.org. Consumers can also obtain free advice through a telephone help line (612-312-2020) while purchasing a home, refinancing, consolidating debt, or taking out a home equity loan. Callers are referred to non-profit agencies with expertise in home ownership education and housing counseling.

B. City Staff Team Discussions/Recommendation

Reflective of the broad partnership coalition of the Don’t Borrow Trouble Minnesota Campaign, there is consensus among the stakeholders that the City staff team met with that consumer education efforts are a helpful and worthwhile component of a City response to the issue of responsible lending. The interest groups also agree that the dedication of City funds to educational outreach would be the single greatest source of assistance to currently operational educational efforts. However, there is considerable disagreement over the efficacy of educational programs in ultimately stemming alleged abuses by unscrupulous lenders, brokers, and contractors. Financial industry representatives contended that educational efforts are making a difference by increasing consumer awareness and stressed the value in the continued operation and expansion of these efforts. In referencing the Don’t Borrow Trouble Minnesota Campaign, Jacqueline Nicholas of the Federal Reserve Bank of Minneapolis states, “[e]ducated borrowers are the best defense against predatory lenders” (attachment 2; Don’t Borrow Trouble Minnesota press release dated 3/5/03). Industry representatives and other public officials also emphasized that educational efforts do not pose the risk of isolating Minneapolis and creating a situation of credit “flight” or the “drying up” of certain types of credit that might ensue from adoption of a regulatory proposal (attachments 12-14).

The advocate community argued that voluntary education albeit helpful does not go far enough to address the root cause of the problem and that the only truly effective way to address the issue is to make predatory practices illegal (attachments 11, 15). Minnesota ACORN recently withdrew from the Don’t Borrow Trouble Minnesota Campaign based on alleged predatory lending by Wells Fargo Financial, one of the corporate members of the campaign partnership (attachment 3). Sam Magavern of the Legal Aid Society of Minneapolis states, “[e]ducation is valuable, but it can never reach more than a fraction of the people being targeted by predatory lenders. Education can help people avoid burglary, but no one would suggest it as a substitute for making burglary illegal” (attachment 11). Advocates stressed the value in targeting educational efforts at impacted neighborhoods, namely low income and predominantly minority neighborhoods, and preferably on a one-on-one basis as the primary way to increase the efficacy of outreach efforts (attachments 15, 17).

The City staff team feels that consumer education and outreach is a vital component of a City response. In discussing the "comprehensive City response to [the] issue of responsible lending that promotes consumer education," the staff team determined that the City possesses unique resources and opportunities that could be devoted to consumer education efforts. The team developed a Work Plan that complements the Don't Borrow Trouble Minnesota Campaign, but also expands on it with the use of these resources (attachment 4). These unique opportunities could include public service announcements by the Mayor and City Council members and inserts in City utility bills to alert potential borrowers to the dangers of predatory lending. In order to maximize available resources while enhancing the overall efficacy of the outreach effort, the staff team targeted certain aspects of the Work Plan at identified, impacted areas of the City. For example, the provision of a predatory lending insert in utility bills could be targeted at those zip codes with residents particularly susceptible to predatory lending tactics, namely the elderly and residents in lower-income neighborhoods. Predatory lending literature could also be distributed and discussed at community events in impacted neighborhoods.

There are several reasons for the staff team's recommendation of support for consumer education efforts. Consensus among the stakeholders on the value of consumer education illustrates the fact that there is the potential for positive results. The timing of City action is also a factor. The primary local educational campaign, Don't Borrow Trouble Minnesota, kicked off in March 2003. It is still too early to evaluate the overall effect of such a campaign in light of this recent start and the difficulty in obtaining hard data on the incidence of predatory lending in Minneapolis. The staff team considers it a prudent option at this time, therefore, to build on these educational programs and to allow time to fully evaluate the effectiveness of these efforts in the future. In light of budgetary constraints, educational efforts also allow the City to address the issue of responsible lending in a manner that is less cost and personnel intensive. In the same vein, many of the Work Plan items build on already existing infrastructure and personnel. However, there are costs associated with many of the items in the Work Plan and, in all likelihood, a sufficient City Council appropriation would be necessary for full implementation. Finally, educational initiatives allow the City to address the issue of responsible lending without the threat of reprisal in a legal action, which would generate considerable expense over a long period of time.

In seeking to develop and enhance a consumer education and outreach plan, the City staff team also discussed funding issues at the state level with regard to the "consumer education account" contained in Minn. Stat. § 58.10, subd. 3. This provision states:

> The consumer education account is created in the special revenue fund. Money credited to this account may be appropriated to the [Commerce] commissioner for the purpose of making grants to programs and campaigns

> designed to help consumers avoid being victimized by unscrupulous lenders and mortgage brokers. Preference shall be given to programs and campaigns designed by coalitions of public sector, private sector, and nonprofit agencies, institutions, companies, and organizations.

It is the understanding of the staff team that during recent budget deliberations at the state legislature, the appropriation for the consumer education account was shifted and it is no longer actively funded. If dedicated funding was restored to the account, it could provide needed financial assistance to currently operational educational campaigns, such as Don't Borrow Trouble, and the City's own outreach efforts in the future.

II. PROPRIETARY/DIVESTMENT POLICIES

These initiatives consist of the City adopting a policy not to do business with predatory lenders or parties associated with predatory lenders. This would include not participating in development projects in which predatory lenders participate, or being involved in financial transactions or deposits with such institutions or their parent entities. Proprietary policies place the burden of disassociation from predatory lenders on the financial entities themselves rather than the City through regulatory oversight or the consumer in an educational campaign. There is the possibility of legal challenge should the City decide to pursue action in this area.

Threshold issues raised by City action in the proprietary category include 1) the form of the policy and 2) the definitional difficulties posed by any attempt to address predatory lending. With regard to the form of the policy, the City could outline the specific divestment principle in an ordinance or resolution. Although there is no clearly appropriate form, there is considerable precedent in the City of Minneapolis for a divestment policy to assume the form of a resolution. The City Council previously adopted divestment resolutions pertaining to Burma, South Africa, and Northern Ireland (attachments 6-7). On the other hand, the City of Chicago unanimously adopted a proprietary ordinance in August 2000. Regardless of the ultimate form, there remains the difficulty of defining predatory lending. There is no consensus on a definition and it often varies from jurisdiction to jurisdiction, since it is ultimately a policy decision on where to set "high cost" loan threshold triggers.

A. Chicago Proprietary Model

With the aim of arriving at a "comprehensive City response to [the] issue of responsible lending," the staff team drafted a proprietary style resolution modeled on the ordinance adopted by the City of Chicago (attachment 5). Staff chose the Chicago model as a starting point because it developed out of a collaborative approach by the financial industry and advocate communities and, therefore, has not faced legal challenge to date. The resolution states that the city will not do business with financial institutions or their affiliates who engage in predatory lending practices. In order to accomplish this goal, a depository is required to sign a pledge attesting that neither it nor its affiliates is or will become a predatory lender (attachment 5; p. 4-5). A predatory lender is defined by meeting one of two initial lending triggers with regard to loans secured by residential real estate. An APR rate trigger of 6% + yield on comparable Treasury securities for first lien loans (8% for junior mortgages) and a fee trigger of 5% of the total loan amount (attachment 5; p. 3). If a loan meets either of the triggers it is considered to be a "threshold loan." A "predatory loan" is correspondingly defined as a "threshold loan" that includes any of the following acts or practices (attachment 5; p. 1-3):

- prepayment penalties unless allowed by state statute
- balloon payments for loans under 15 years
- flipping
- loans not based on borrower's ability to repay
- financing fees accounting for more than 6% of loan amount
- negative amortization
- direct payments to home improvement contractors
- inclusion of credit insurance without disclosure

Predatory lenders are then defined as a financial institution that has made 25 or more predatory loans or 5% of the total number of loans made in a 12-month period. The resolution vests authority in the chief financial officer to identify predatory lenders and to divest if necessary (attachment 5; p. 1).

B. City Staff Team Discussions/Recommendation

In discussing the draft resolution with the stakeholders, the staff team learned that neither group is in favor of a proprietary policy pursued in isolation. Representatives from the banking community opposed the resolution on the grounds that it imposes another restriction on the already heavily regulated banking industry. Joe Witt, Executive Vice President of the Minnesota Bankers Association, states:

> Banks will need to spend additional time and resources complying with the city's [policy], which will affect their pricing for city deposits. As a result, city deposits will be less attractive to local banks. The city should work to encourage local investment rather than make it more difficult and costly. The draft misses the mark because it focuses so heavily on deposit-taking institutions, which are not even the problem (attachment 9).

The advocates continued to reiterate their support for a full regulatory ordinance that would also include proprietary and educational components. They felt that a proprietary policy alone would not address the alleged abuses occurring in the subprime market. In commenting on the draft resolution, Becky Gomer, the Executive Director of Minnesota ACORN states, "[t]he most basic problem with the draft based on the Chicago ordinance is that it would have almost no impact on the subprime market and efforts to restrain predatory lending in Minneapolis" (attachment 8). She continues, "[t]he

Chicago ordinance's definition of 'points and fees' and the 'points and fees' threshold ensure that it would not apply to any of the very high-fee loans currently being made, which is the source of the most significant damage from predatory lending."

Based on concerns about the operation and effect of a divestment strategy, the City staff team does not support a proprietary policy. It would be particularly difficult to enforce such a policy in practice. Although the draft resolution is somewhat self-policing in that financial entities wishing to conduct business with the City are required to submit a pledge, there is no provision for active review or oversight of loan transactions. In practice, therefore, the policy has the potential to be largely symbolic. In conversations with officials at the Chicago Department of Housing, they indicated that although pledges were received from the vast majority of financial institutions, there was very little in the way of actual enforcement of the substantive terms of the ordinance and that no divestments had occurred to date. However, while the actual effects of such a policy may be minimal, there is the potential for significant disruption of the City's established financial relationships. The pursuit of mere symbolism alone may not be worth the risk that a divestment strategy could pose to the City's banking relationships. Upon further evaluation and weighing of the potential benefits and costs, the staff team does not recommend adoption of a proprietary policy.

III. REGULATORY ORDINANCE

ACORN's proposed predatory lending ordinance ("ACORN ordinance") falls squarely in the third category, which is the category of furthest reach and greatest likelihood of a legal challenge. Regulatory provisions, such as the ACORN ordinance, seek to comprehensively address the issue of predatory lending by prohibiting certain mortgage lending practices in association with "high cost" loans. These types of provisions are the most susceptible to legal challenge. The legal issues on which the City would be challenged are discussed below.

A. ACORN Ordinance

The ACORN ordinance is structured to provide substantive protections for borrowers on identified "high cost" loans. The "high cost" loan threshold is established by reference to two lending triggers that implicate the terms of the loan on its face: 1) a rate (APR) trigger and 2) a points and fees trigger. The rate trigger is met by first lien loans with an APR of 6 percentage points above the rate on 15 year U.S. Treasury bonds (8 percentage points for junior mortgages). The points and fees trigger is met by loans with at least 3 percent of the bona fide principal amount comprising points and fees (or $900, whichever amount is greater) (attachment 10; p. 5-6).

Once it is determined that a mortgage loan is "high cost" because it meets one or both of the triggers, focus turns to identification of specific abusive lending practices in conjunction with extension of the "high cost" loan terms. In general, these abusive circumstances involve practices that strip equity away from a homeowner. The ACORN ordinance prohibits a number of practices on “high cost” loans. The prohibitions include (attachment 10; p. 8-12):

- No refinancing without borrower benefit
- No lending without regard to repayment ability
- No financing of excessive points and fees
- No high cost lending without housing counseling
- No increased interest rate upon default
- No advance payments
- No modifications or deferral fees
- No prepayment penalties
- No balloon payments
- No payments directly to contractors
- No call provisions
- No refinancing special mortgages
- No financing of credit insurance

In order for a loan to be deemed “predatory,” it must meet the “high cost” loan threshold and violate one or more of the lending prohibitions noted above. The ACORN ordinance then defines a “predatory lender” as follows:

> A business entity that, through itself and/or an affiliate has made, within the previous 12-month period, predatory loans that comprise either: 5 percent of the total annual number of loans made; or 10 individual loans, whichever is less (attachment 10; p. 8).

The ACORN ordinance provides for enforcement via a civil action and/or criminal prosecution (attachment 10; p. 12-14). The ordinance creates a third party civil cause of action for an “aggrieved borrower or an organization acting on behalf of an aggrieved borrower” against a lender who violates the terms of the ordinance. It also allows the City Attorney to bring a civil action for a violation of the ordinance and provides for imposition of civil penalties of up to $50,000 per violation. Finally, the ordinance provides for criminal prosecution of ordinance violations by the City Attorney’s Office.

B. Legal Issues

1. Municipal Authority/Preemption

As a creature of the legislature, a municipal corporation has no inherent powers and possesses only those powers expressly granted by its charter, general state laws, or the state constitution. However, in addition to these express powers, a municipal corporation may exercise those powers necessarily or fairly implied in or incident to the express powers. *See* Mangold Midwest Co. v. Village of Richfield, 247 Minn. 347, 143 N.W.2d 813 (1966) (attachment 22; adoption of so-called “Dillon’s Rule” by the

Minnesota Supreme Court); *see also* The Law of Local Government Operations, Rhyne, Charles, p. 64-65.

The threshold determination when considering a regulatory ordinance, such as the ACORN ordinance; therefore, is whether the City can locate the specific authority to regulate in the particular field at issue. Minneapolis is a home rule charter city. The Minneapolis City Charter confers on the City Council a power to regulate and license. Ukkonen v. Gustafson, 309 Minn. 260, 264, 244 N.W.2d 139, 141 (1976). Chapter 4, § 5 of the Charter provides as follows:

> The City Council shall have full power and authority to make, ordain, publish, enforce, alter, amend or repeal all such ordinances for the government and good order of the City, for the oppression of vice and intemperance, and for the prevention of crime, as it shall deem expedient, and in and by the same to declare and impose penalties and punishments, and enforce the same against any person or persons who may violate the provisions of any ordinance, passed and ordained by it, and all such ordinances are hereby declared to be and have the force of law.

This provision is known as the "general welfare" clause of the City Charter. This provision is followed by a list of 42 areas for which specific authority is granted, including various businesses, professions, and other activities that may be regulated and licensed by the City Council. There is nothing in this specific list to indicate that the City Council's powers extend to the mortgage lending industry. *See* Maytag Co. v. Commissioner of Taxation, 218 Minn. 460, 463, 176 N.W.2d 37, 40 (1944) ("[w]here a statute enumerates the persons or things to be affected by its provisions, there is an implied exclusion of others"). However, the Minnesota Supreme Court held that the specific enumeration therein does not limit the things that may be regulated pursuant to the general welfare clause. Crescent Oil Co. v. City of Minneapolis, 175 Minn. 276, 221 N.W. 6 (1928). In discussing the powers of the Minneapolis City Council in the case of State v. Morrow, 175 Minn. 386, 388, 221 N.W. 423 (1928), the Court concluded:

> Such a general welfare clause as that found in the charter of Minneapolis is intended to make the powers of the council sufficiently expansive to enable them to meet and provide for new conditions as they arise.

Furthermore, a general welfare clause will be construed liberally to allow self-protection by the municipality. Mangold Midwest Co., 143 N.W.2d at 820. An expansive interpretation of the general welfare clause, therefore, would arguably give the City power to regulate targeted lending businesses whose activities adversely affect the welfare and good order of the City and its inhabitants.

If a court were to determine that the City has the authority pursuant to its general welfare clause to adopt the ACORN ordinance, the next issue would be whether state or federal law preempts it. The doctrine of federal preemption provides that states or local governments may not pass laws inconsistent with federal law. There are three possible categories of federal preemption: (1) "express preemption," where a federal statute expressly prohibits state or local regulation; (2) "conflict preemption," where compliance with both federal law and the local law is impossible; and (3) "implied preemption," where the federal regulatory scheme is so pervasive that it is assumed to preclude enforcement of state or local laws on the same subject. *See* Cipollone v. Liggett Group, Inc., 505 U.S. 504 (1992).

Particularly relevant federal legislation in the residential mortgage lending area with respect to federal preemption includes the Truth in Lending Act (TILA) and the Home Ownership Equity Protection Act (HOEPA). TILA requires that lenders provide certain disclosures to borrowers in connection with mortgage loans, including the total amount financed, finance charge, and annual percentage rate. 15 U.S.C. § 1638(a). TILA also grants the borrower a qualified right of recision for loans secured by a principal residence, not including home purchase loans. 15 U.S.C. § 1635.

HOEPA subsequently amended TILA to prohibit certain predatory terms in "ultra-high-cost" loans. HOEPA's protections are triggered by loans at least 8 percentage points above the yield on Treasury securities of comparable maturity for first-lien loans (10% for second liens) or with points and fees comprising at least 8 percent of the loan amount. 15 U.S.C. § 1602(aa). For the group of loans covered by HOEPA, the law provides significant protection. Many of these protections are similar to those in the ACORN ordinance. They include additional disclosure requirements, limitations on prepayment penalties, a prohibition on higher interest rates after default, limitations on balloon payments, a prohibition on negative amortization, a ban on "asset-based lending," and certain restrictions on home improvement scams (including a ban on direct payments to contractors) 15 U.S.C. § 1639.

Congress has not expressly or impliedly occupied the entire field of predatory lending regulation with either piece of legislation. In addition, the inclusion of an express federal preemption provision in a recent House of Representatives bill, H.R. 833 – "Responsible Lending Act," supports the conclusion that Congress has not previously preempted state or local law with respect to predatory lending (note that the bill did not advance out of committee). As long as a proposed ordinance would operate within the scheme and scope of federal law and not create an impediment to the achievement of the goals and purposes of any federal action, a court will probably not find it federally preempted.

Even if passed pursuant to legitimate municipal authority and not preempted by federal law, state law may preempt a municipal ordinance. State preemption occurs in four situations: (1) when a conflict exists between a state statute and a local ordinance; (2) where the legislature intended to occupy the field; (3) where the statutory scheme includes implicit preemption of the subject matter; and (4) where the legislature explicitly preempts the field. Mangold Midwest Co., 143 N.W.2d at 819.

Conflict preemption generally occurs when a statute and an ordinance contain "express or implied terms that are irreconcilable." Id. A conflict exists if an ordinance "permits what the statute forbids" or if the ordinance "forbids what the statute expressly permits." Id. No conflict exists, however, if the ordinance is simply complementary or in furtherance of the statute. Id. Further, there is no conflict when a city or other local government entity adds regulations that provide for greater consequences than those covered by the state. City of Duluth v. Evans, 158 Minn. 450, 197 N.W. 737 (1924).

Local ordinances also may be preempted where the legislature has fully and completely covered a subject matter, indicated that the field is solely of state concern, or that the subject matter itself is such that local regulation would have an unreasonably adverse effect on the state population. Mangold Midwest Co., 143 N.W.2d at 819. This can fairly be divided into two distinct areas: occupation of the field or preemption by implication. Occupation of the field exists where the subject matter has been fully and completely legislated on the state level, leaving no room for local governments to operate. Implied preemption occurs where the scheme itself, or some other language by the legislature implies that local action would be unwanted and against the goals of the legislation. The legislature could do so by stating that the legislation is being passed in order to bring regularity or consistency to a subject matter.

In addition to the consumer protection and fraud statutes, Minnesota law includes a number of provisions that attempt to address certain lending practices. Minn. Stat., § 58.13 (2002) prescribes specific "standards of conduct" for and requires certain disclosures by any person acting as a "residential mortgage originator or servicer" and prohibits various misleading and deceptive actions with regard to mortgage lending. These prohibitions include extending a loan without regard to the borrower's ability to repay. The Department of Commerce is charged with enforcement of the statute.

Minn. Stat., § 58.137 (2002), which took effect on January 1, 2003, regulates interest, points, fees, and other charges in home mortgages, including prepayment penalties and lender fees. It also includes a verbal and written disclosure requirement for prepayment penalties in certain circumstances. Minn. Stat., § 58.137, subd. 2 (2002).

Minn. Stat. § 47.21, subd. 1 is of particular concern with regard to the issue of state preemption of a local ordinance. The provision was amended during the same legislative session that produced Minn. Stat. § 58.137 above, which addressed certain lending practices (see above). The provision, entitled "[l]imits relating to loans" states (amendment is underlined):

> No other law in this state, <u>except as stated in section 58.137</u>, prescribing the nature, amount or form of security or requiring security upon which loans or advances of credit may be made, or prescribing or limiting interest rates upon loans or advances of credit, or prescribing or limiting the period for which loans or advances of credit may be made,

> shall be deemed to apply to loans, advances of credit or purchases . . .

See also Minn. Stat. § 47.204, subd. 1 (similar language; "[t]emporary removal of mortgage usury limits"). Since the provision was amended only to add an exception for the newly enacted Minn. Stat. § 58.137 (same bill), it raises the question of whether it is the intent of the legislature, express or otherwise, to preempt any other law regulating mortgage lending.

However, although these state statutes address certain aspects of residential mortgage lending, it does not appear that the state has taken a patterned or comprehensive approach to the issue overall. This might indicate that the field of residential mortgage lending is not solely a matter of statewide concern. Local government units tend to be given more leeway in preemption issues where the matter primarily affects the local populace. American Dog Owners Ass'n. Inc., v. City of Minneapolis, 453 N.W.2d 69, 72 (Minn. Ct. App. 1990). In American Dog Owners, the court held that the City had a particular local interest in taking appropriate measures for animal control. Id. The court did not imply that there was no interest on the state level in animal control, but rather that the City of Minneapolis had a particular interest that warranted further protection and regulation. Id. This case illustrates the importance of including Minneapolis-specific findings regarding predatory lending in any regulatory ordinance, which would support the contention that the issue is one of particular local interest and urgency.

However, a court could also conclude that predatory mortgage lending is an issue of statewide concern based on the proliferation of federal and state law on the subject. In Welsh v. City of Orono, 355 N.W.2d 117, 120 (Minn. 1984) the Minnesota Supreme Court reiterated "Dillon's Rule" as adopted in Mangold by stating:

> A municipality has no inherent powers, but only such powers as are expressly conferred by statute or are implied as necessary in aid of those powers which are expressly conferred. If a matter presents a statewide problem, the implied necessary powers of a municipality to regulate are narrowly construed unless the legislature has expressly provided otherwise.

In applying this doctrine, the Minnesota Court of Appeals subsequently held that the City of Minneapolis' provision of health insurance coverage to persons related to or living with municipal employees was a matter of statewide, not purely local concern, and thus its power to legislate on the matter had to be narrowly construed. Lilly v. City of Minneapolis, 527 N.W.2d 107 (Minn. Ct. App. 1995). The court specifically noted that the preambles to the resolutions at issue both indicated that the City viewed its grant of insurance benefits to same sex partners of employees as a means to combat discrimination. The court then concluded that discrimination is a statewide concern and the City's actions were *ultra vires* and without legal force. Id. at 111. If a court were to determine that predatory mortgage lending is an issue of statewide concern and not a purely local matter, it would bolster the argument that the City lacks municipal authority to regulate in the field. Since the mortgage lending industry is dominated by financial institutions with a statewide or national presence who are operating in many localities, a court may be reticent to allow various localities in Minnesota to set their own standards for loan terms and lending practices.

2. Enforcement Mechanism

The ACORN ordinance provides for enforcement of its terms by either a private party or the City Attorney's Office. The ACORN ordinance's primary direct enforcement mechanism is the granting of a private civil cause of action to an "aggrieved borrower or an organization acting on behalf of an aggrieved borrower or borrowers" (attachment 10; p. 12). With regard to remedies in the event a court finds that a lender violated the ordinance, the ordinance provides for actual damages, exemplary damages, and attorney's fees and costs. Exemplary damages are calculated according to the amount of points and fees charged for the home loan plus ten percent of the total loan amount.

The ACORN ordinance also provides for enforcement by the City Attorney's Office through a civil or criminal enforcement action (attachment 10; p. 12-14). With regard to a civil action brought by the City Attorney's Office, the ordinance provides for imposition of civil penalties by a court against a violating lender in an amount ranging from $500 to $50,000 per violation. Each home loan made in violation of the ordinance is deemed a "violation." The provision also allows for the award of costs and attorney's fees to the City. Finally, the ordinance also allows the City Attorney's Office to criminally prosecute a lender who violates the terms of the ordinance.

Every time a city seeks to act in a particular area, a source of authority for that action, whether it is specific authority or general authority, must be found. Home rule charter cities, like Minneapolis, can obtain the authority either from a subject matter statute, or, if the state has not preempted the City from acting in a certain area, the city may obtain authority from its home rule charter. Assuming the City is not preempted from acting in the area of mortgage lending, of the three enforcement mechanisms provided, there is only authority for criminal prosecution of an ordinance violation. In Chapter 4, § 6 of the Minneapolis Charter, it provides that the "City Council may prescribe punishment for the breach of any ordinance of the City to the extent of a fine not exceeding $700, and imprisonment not exceeding 90 days, or both" (Minn. Stat. § 609.034 increased maximum penalty to $1000). The City Charter does not give the City Council the power by legislation to authorize civil actions or civil penalties. That portion of the ordinance authorizing borrowers to bring a civil action, therefore, exceeds the City Council's legislative powers.

The well-established general rule is that a municipal corporation cannot create by ordinance a right of action between third persons. McQuillin's The Law of Municipal Corporations, vol. 6, § 22.01, p. 388. Under this rule, an ordinance cannot directly create a civil liability of one citizen to another. For example, the City cannot by ordinance create a third party civil cause of action for a borrower to sue a lender. Since there is no authority in the Minneapolis Charter for the City Council's creation of a civil cause of action to enforce a regulatory ordinance, those portions pertaining to "civil enforcement and remedies" must be stricken (attachment 10; p. 12-13). The City does currently file civil tenant remedies actions against landlords and/or property managers for Housing Maintenance Code violations. State law authorizes those actions, however, in Minn. Stat. § 504B.395 *et seq*. The City has traditionally criminally prosecuted landlords for violations of the Housing Maintenance Code pursuant to the authority granted by the Charter in Ch. 4, § 6. In the context of the Housing Maintenance Code, the City Council did not create by ordinance the right of the City Attorney's Office to file a civil action.

Courts in other jurisdictions have struck down ordinances granting a private cause of action. In McCrory Corporation v. Fowler, 319 Md. 12, 570 A.2d 834 (Md. Ct. App. 1990), Montgomery County, a home rule county, enacted an ordinance providing a private cause of action for violations of the county's employment discrimination ordinance. In striking down the ordinance as a non-local law, the court stated, "[i]n creating a new judicial cause of action between private individuals, [the ordinance] encroaches upon an area which heretofore had been the province of state agencies." Id., 319 Md. at 20, 570 A.2d at 838. The court continued, "the creation of new causes of action in the courts has traditionally been done either by the General Assembly or by this Court under its authority to modify the common law of this State" and that "the creation of new judicial remedies has traditionally been done on a statewide basis." Id.; *see also* Mack v. City of Detroit, 243 Mich. 132, 620 N.W.2d 680 (Mich. Ct. App. 2000) ("plaintiff and the majority base their positions on an unsupported assumption: that a city charter can even create a private cause of action. Neither plaintiff's brief nor the majority's opinion points to any authority for the proposition that a city charter (or ordinance for that matter) can even explicitly create a right to a private cause of action").

C. City Staff Team Discussions/Recommendation

The ACORN ordinance is a full regulatory ordinance that also includes proprietary and educational elements. Based on the experience of other jurisdictions' attempts to regulate the mortgage industry, the City's adoption of the ACORN ordinance will likely result in a lawsuit. The mortgage industry's arguments will center on the two central legal concepts mentioned above: 1) municipal authority to enact the ordinance and 2) preemption. Although these legal questions are open to debate, it is the conclusion of the City Attorney's Office that there is strong legal authority supporting the City's ability to adopt such a regulatory ordinance.

The advocate community offered the ordinance as the "only meaningful solution to the prevalence of [predatory] practices" because it includes bright line prohibitions with lower "high cost" loan threshold triggers than current federal law (HOEPA) (attachment 11). Mr. Magavern states, "[t]he biggest problem faced by our clients is the loan that includes unjustifiably high interest rates and fees, abusive and misleading terms, and yet is entirely legal under current law" (attachment 11). During the meetings with the City staff team, the advocates argued that the ACORN ordinance fills many of the gaps in current federal and state law because it increases the reach of the law by lowering the trigger thresholds while expanding many of the substantive protections. They contended that the current marketplace fails to protect vulnerable borrowers and that current law is insufficient. Although the advocates recognize that the state legislature is the preferred forum for a comprehensive anti-predatory law, they argue that the City must act to protect its citizens in the absence of any legislative developments at the state level.

Financial representatives and other public officials contended that additional regulation, such as the proposed ACORN ordinance, will have the reverse effect of drying up credit for the borrowers the proposed regulation is trying to help (attachments 12-14). Instead, the financial community urged greater enforcement of existing law. Todd Klingel, President of the Minneapolis Regional Chamber of Commerce, states:

> Any action taken at the local level will have the effect of isolating Minneapolis, making it more difficult for high risk borrowers to purchase a home. We are already seeing evidence of this in jurisdictions around the country where well-meaning attempts to eliminate financial predators have actually reduced the opportunity for subprime borrowers (attachment 12).

Similarly, Sam Grabarski, President and CEO of the Minneapolis Downtown Council, states:

> The Board of Directors of the Minneapolis Downtown Council recommends that the City of Minneapolis not adopt a proposed new Predatory Lending Ordinance. Minneapolis is the state's center for responsible banking, so the goal should be to promote consumer education and vigorous enforcement of existing anti-predatory laws. We must not create an environment where people or families will find it more difficult to borrow money to purchase housing (attachment 13).

As support for their argument that additional regulation as embodied in the ACORN ordinance may have the adverse effect of a diminishment of certain types of credit lending, the financial representatives pointed to studies of the market effects of North Carolina's anti-predatory lending law (attachment 21). The financial representatives also stressed that additional regulation will result in increased costs to the borrower as the additional expenses of compliance with the regulation are ultimately passed on to the consumer. In the same vein, the financial industry cites increased costs to the consumer as an ancillary effect of overall industry compliance with a patchwork legal and regulatory environment.

In light of the significant costs and legal questions surrounding the City's adoption of a regulatory ordinance and the likelihood that a lawsuit would ensue, the staff team does not support adoption of a regulatory ordinance. There is currently no regulatory municipal ordinance in effect and operation in the country. Although the regulatory ordinance of the City of Oakland has been upheld at both the trial court and appeals court levels, it is still enjoined pending full resolution of the legal course of action. Similarly, if the City of Minneapolis adopts a regulatory ordinance, the ordinance will likely be enjoined once the lawsuit is filed. During the extensive amount of time it takes a lawsuit and accompanying appeals to progress through the courts, therefore, borrowers will not benefit from the substantive protections provided by the ordinance. The staff team feels that there are other options available to the City that can have a more immediate effect of aiding its citizens.

Nevertheless, if the City seeks to adopt the ACORN ordinance as proposed, it is the staff team's opinion that the City Council lacks the requisite municipal authority to create a civil cause of action within the ordinance and that portion must be stricken. The City has Charter authority to prosecute ordinance violations; however, the punishment will be limited to the current misdemeanor amounts of a maximum $1,000 fine and/or 90 days in jail. Since this is not an area of current focus for City prosecutors, it must be determined whether there are sufficient enforcement resources available. In addition, the City must also identify personnel with sufficient financial knowledge to adequately evaluate and analyze loans for violations of the ordinance. Ordinances from other jurisdictions place this responsibility with the chief financial officer or another appropriate position within the respective finance department. Although it is not possible to provide a specific regulatory cost estimate because it is unclear how many loans may fall within the purview of the ordinance, adequate enforcement of such an ordinance by the City would require additional monetary resources and personnel.

IV. OTHER ISSUES

A. Licensing

In meeting with the stakeholders on the issue of predatory lending, the City staff team did not confine the dialogue to the three primary approaches discussed in the April 17, 2003, memorandum from the City Attorney's Office. As an alternative to a regulatory ordinance with a private right of action, the advocates suggested adoption of a City ordinance licensing "high cost" lenders (attachments 15, 17-18). The substantive protections of the ACORN ordinance could be imposed as a condition of obtaining a license and the City's costs could be recouped through the licensing fee. Although the details of this proposal were not fleshed out, the staff team met with personnel in the City's Regulatory Services Department in an attempt to understand the personnel and budgetary requirements for a licensing program in general. It is extremely difficult to provide an estimate at this time because the contours of the specific proposal are not known and the number of "high cost" lenders and loans in the City is not known. However, since the City does not currently regulate the lending industry, it would doubtless require additional personnel. The additional federal HMDA reporting requirements in 2004 may also provide a clearer picture of the incidence of "high cost" lending in the City. If City licensing of "high cost" mortgage lenders is viewed as a possible option, the staff team suggests revisiting it in the future.

Although the staff team does not currently support a City licensing scheme, there is support for a state licensing bill. While a City licensing program would raise concerns with credit flight and increased costs to consumers, a statewide law would not serve to "isolate" Minneapolis. Pat Martyn provided a copy of a bill that was previously introduced in the legislature and will be presented again in the 2004 legislative session that provides for registration of individual residential mortgage originators (attachment 20). Current state law contained in Minn. Stat. §58.13 only requires the licensing of mortgage origination companies and not the licensing or registration of individual employees of those companies. It appears that the advocate community would lend support to such a bill. As part of the City's IGR package, the staff team suggests City support for a state licensing law.

B. Enforcement Gaps

As a specific component of a City response to the issue of responsible lending, the City Council directed staff to "promote enforcement of State and Federal laws already in force as well as identifying gaps in existing laws." This direction highlights the fundamental difference the staff team observed between the positions of the advocates and the financial industry on the proposed regulations. The advocate community contended that the marketplace is failing to protect vulnerable borrowers and current laws are insufficient to curb the alleged abuses. Minnesota ACORN provided anecdotal evidence of several cases where a consumer was left without an adequate remedy at law to address a situation of abusive lending (attachment 1). The financial industry countered that current laws are sufficient, but that better enforcement and not additional regulation is needed to address alleged abuses. As support for their position, the financial representatives referred to the recent multi-state settlement with Household Financial (attachment 23).

Since the staff team has not had active involvement in the field of mortgage lending, it is very difficult to identify the "gaps" in existing law. There are a large number of federal and state lending laws, in addition to consumer fraud laws, with potential applicability to the topic. The team focused primary attention on the relevant jurisdiction's most oft-cited laws on the topic, namely federal HOEPA and Minn. Stat. § 58.13 ("Minnesota Residential Mortgage Originator and Servicer Licensing Act"), during the course of its discussions. In addition, the staff team sought guidance from the stakeholders on this issue of enforcement "gaps." In an October 23, 2003 letter, Mr. Magavern cites several abusive circumstances often associated with predatory lending that he indicated remain "legal" under current law (attachment 15). In response, Pat Martyn (MN Association of Mortgage Brokers) annotated Mr. Magavern's letter with citations to the federal or state law that addresses the abusive circumstance cited (attachment 16). Most of the annotations refer to federal law (HOEPA). It is instructive to note that many of the prohibitions in the proposed ACORN ordinance are already addressed in HOEPA. The advocates argued, however, that the “high cost” loan threshold triggers in HOEPA are too high and that many predatory lenders simply set their APR or points and fees at a level right below the HOEPA triggers.

In analyzing the remaining annotations, it appears that there are three circumstances that are not addressed by current law:

- there is no housing counseling requirement in federal or state law
- there is no prohibition on a lender charging modification and deferral fees
- there is no prohibition on the refinancing of special mortgages given by the government or non-profits

Of the three, the refinancing of special mortgages is the most onerous because there is no situation where a borrower could benefit from such a situation. The City staff team supports legislation, therefore, that would close these gaps.

With regard to counseling, Sam Magavern voiced support for mandatory third party review or independent counseling as a condition of making “high cost” loans (attachments 17-18). Although a specific proposal was not offered, it was envisioned that the counseling requirement would be embodied in a City ordinance. A borrower’s receipt of loan counseling would be evidenced by a signed piece of paper that must be included in the loan closing documents. In response, Pat Martyn pointed out that ACORN supported state legislation that “loan applicants receive a written statement strongly urging them to run the paperwork by an independent loan counselor” (attachment 16). He also correspondingly referred to the wide variety of voluntary counseling options available in the area.

In addition to concerns about the increased costs to borrowers, the City staff team questions how a mandatory counseling ordinance would be enforced. In order to verify that the counseling document is included in the loan closing package, there would need to be some sort of third party review of all “high cost” loan documents. Depending on the volume of “high cost” loans, this oversight may require additional personnel. In addition, violation of a municipal ordinance would be prosecuted by the City Attorney’s Office. It is questionable whether this “penalty” would be sufficient to insure compliance with the counseling requirement and whether current staffing would allow for the active enforcement of the provision. On the other hand, a state law requirement that borrowers receive a written statement urging them to seek independent loan counseling does not give rise to these overt enforcement problems because the statement functions as a warning only and does not mandate conduct.

With regard to enhancing the enforcement of existing state law, the City staff team also proposes support for legislation authorizing the Minnesota Attorney General to enforce Minn. Stat. § 58.13 (“Minnesota Residential Mortgage Originator and Servicer Licensing Act”). This provision prescribes specific “standards of conduct” for and requires certain disclosures by any entity acting as a “residential mortgage originator or servicer.” It also prohibits various misleading and deceptive actions with regard to mortgage lending, including extending a loan without regard to the borrower's ability to repay. The Department of Commerce is charged with enforcement of the statute. Although the stakeholders the City staff team met with fully support Minn Stat. § 58.13, they also cite little to no active enforcement of its terms by the Department of Commerce. In order to increase the ability of the state to enforce the terms of Minn. Stat. § 58.13, therefore, the City staff team proposes support for legislation authorizing the Attorney General to enforce the statute.

V. SUMMARY OF RECOMMENDATIONS

After extensive analysis and discussions with the advocate community and financial industry, the City staff team became acutely aware of the divergent policy positions of these groups. The advocates contend that a regulatory provision such as the proposed ACORN ordinance is the only effective way to curb the alleged abuses. Emphasizing concerns with credit flight should Minneapolis choose to regulate alone, the financial industry representatives contend that consumer education and better enforcement of existing law is the most prudent course of action. Even though they offer solutions on opposing ends of the spectrum, there are a few areas of convergence between the stakeholders. There is consensus to some degree that consumer education is a valuable component of a City response to the issue of responsible lending. There is also agreement on the need for better enforcement of the law.

Based on these discussions and analysis, the City staff team developed a two-pronged response to the issue of responsible lending that combines educational outreach with support for state legislation. As a leading component of this response, the staff team recommends adoption of the attached educational outreach work plan. Since it is likely not susceptible to legal challenge, implementation of its terms can begin immediately. In addition, the plan does not run the risk of isolating Minneapolis and possibly creating a situation of credit flight. Finally, the plan acknowledges the financial reality facing the City and strives to use existing City and external (Don't Borrow Trouble Minnesota) resources to accomplish its objectives.

Based on the extensive concerns associated with municipal regulatory action, the staff team strongly supports state efforts to curb predatory lending. This support for state legislation emphasizes legislation that would close "gaps" in current law, bolster enforcement, and devote additional resources to the issue. The City staff team proposes that the City Council adopt as part of its 2004 legislative program the following:

- Support full funding of the Consumer Education Account so that the Commerce Commissioner may assist and educate consumers to avoid being victimized by unscrupulous lenders

- Support legislation to license or register individual residential mortgage originators

- Support legislation requiring lenders to provide loan applicants with a written statement strongly urging them to discuss their loan paperwork with an independent loan counselor

- Support legislation prohibiting the refinancing of special mortgages provided by the government and nonprofit organizations

- Support legislation prohibiting or limiting the ability of a lender to charge modification and deferral fees

- Support legislation authorizing the Minnesota Attorney General to enforce current Minn. Stat. § 58.13, the “Minnesota Residential Mortgage Originator and Servicer Licensing Act” and appropriate sufficient funding therefor