PROMOTING HOME OWNERSHIP BY ENSURING LIQUIDITY IN THE SUBPRIME MORTGAGE MARKET

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

AND THE

SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY

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PROMOTING HOME OWNERSHIP BY ENSURING LIQUIDITY IN THE SUBPRIME MORTGAGE MARKET

Wednesday, June 23, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT, AND
SUBCOMMITTEE ON HOUSING AND
COMMUNITY OPPORTUNITY
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittees met, pursuant to call, at 10:08 a.m., in Room 2128, Rayburn House Office Building, Hon. Robert Ney and Hon. Spencer Bachus [chairmen of the subcommittees] presiding.

Present: Representatives Bachus, Ney, Baker, Royce, Kelly, Biggert, Fossella, Gary G. Miller of California, Hart, Capito, Tiberi, Hensarling, Garrett, Kanjorski, Waters, Sanders, Maloney, Gutierrez, Velazquez, Watt, Ackerman, Sherman, Meeks, Lee, Lucas, Crowley, Israel, McCarthy, Miller of North Carolina, Scott, and Davis.

Chairman NEY. [Presiding.] Today, the two subcommittees meet to continue our look at the subprime market and its importance to consumers. Last year, Chairman Bachus and I began holding roundtables to discuss abusive lending practices in subprime lending and how we can assure credit availability for those who need and want it. We are pleased to also have Chairman Baker with us today who has a wealth of knowledge on this issue and has spent a long time looking at this issue.

Last fall, we held our first joint hearing to examine abusive lending practices. This spring, we followed that by holding a hearing looking at the subprime lending market. For the first time in the predatory lending discussion, we looked at the growing class of subprime borrowers and their role in the mortgage marketplace. Today, we will look at another vital piece of the subprime market. The United States mortgage market is the deepest and most affordable in the world. Due to the evolution of unique funding structures for mortgages, Americans pay less for mortgages than almost anywhere else in the world. As a result, this country has the world's highest homeownership rate, although there is a lot more that can be done, especially in areas of minority homeownership.

However, the unique funding structure that has been long established for the prime mortgage market is far less mature for the subprime mortgage market. Only recently has it become common

for a majority of subprime loans to be packaged and sold to investors. I believe that this evolution has led to lower and more uniform rates for subprime loans, saving consumers money while making credit more widely available. However, states and cities have begun passing laws that dramatically affect the availability of funds for subprime lenders.

In a well-intentioned attempt to end abuse of lending practices, some State and local governments passed laws extending liability for fraudulent origination practices to those in the secondary market that purchased the loan in a pool, but had no hand in actually writing the loan. These strict assignee liability laws threaten the availability of credit in the subprime market. I think we saw this most evident in Georgia at the time when it caused such a problem, people said, fine, we are just not going to do business. And of course, the legislature came back, there were some editorials, and they changed parts of that law. These strict assignee liability laws threaten the availability of credit, frankly, in the subprime market. Acting as a usury cap on mortgage lending, these laws effectively prevent people from receiving mortgages.

The recent case study on the problems with assignee liability, and I mention, of course, recent case studies in Georgia, where the State legislature passed an incredibly onerous law with strict assignee liability. That law led many secondary market players to withdraw from the Georgia market, drying up the credit for the borrowers. Of course, I mentioned the rest about the editorials that followed, and then the Georgia legislature passed a partial fix to the problem that provided some lending opportunities, but we still do not know what will be the lasting effect of these predatory lending statutes on the availability of credit.

In order to better understand the impact of laws like Georgia's, this hearing will give our subcommittees a chance to hear from a distinguished group of witnesses on the availability of subprime mortgages. I think this hearing is timely and important to this committee's duty of ensuring access to credit for Americans. I also want to thank Congressman Lucas and a wide variety of other members on both sides of the aisle, Congressman Sherman and others, who have expressed interest in this issue. We appreciate it. I know it can be a controversial and tough issue, but I think it has to be looked at and dealt with. So I again appreciate members who have been willing to look at this.

With that, I will recognize Congressman Sherman.

[The prepared statement of Hon. Robert W. Ney can be found on page 52 in the appendix.]

Mr. SHERMAN. Thank you, Mr. Chairman.

The recent actions by the OCC have created an absurd situation where a certain class of lenders has the lowest common denominator of virtually no restrictions, and that will eventually lead to some bad actors, if it has not already, that will tarnish the image of all lenders and result in a backlash that will be harmful even to that subset of lenders, the national banks that think they enjoy the OCC's liberation from State regulation.

The answer is that Congress needs to take action. The most immediate action we should take is to get rid of what the OCC has done, which is to substitute itself for this committee and this Con-

gress. It may be necessary for us to do that as part of a package where we establish real solid consumer protections, not lowest common denominator, and at the same time preempt this glowing plethora of state and even local regulation. We need good regulation for all Americans, and not a patchwork city-by-city, county-by-county, or even state-by-state.

We need the competition that comes from efficiency, which comes from offering a product nationwide. I hope that both sides in this debate will not grab onto their own definition of nirvana; that consumer groups will not say, well at least in Berkeley, we have every regulation we want; God forbid we should lose that paradigm. And some national bank should not say, well, we have the OCC for now; we do not have to worry about anything. And instead unite behind solid consumer protections that represent a middle ground.

I hope these hearings lead to that result, and I yield back.

Chairman NEY. Thank you.

Mr. Chairman, Mr. Bachus?

Mr. BACHUS. Thank you, Mr. Ney.

First of all, I want to commend you for having this hearing of our two subcommittees. By way of review, this is the third hearing we have had on this matter. Our first hearing, we addressed ways to combat abusive lending practices in the nonprime or subprime area, and to address them without jeopardizing the availability of nonprime or subprime loans to those with less than perfect credit.

Our second hearing, we focused on looking at actually who the nonprime or subprime borrowers were, their profiles, and the advantages that nonprime and subprime mortgages, the benefits and advantages to those borrowers, and also some of the risks inherent in the nonprime or subprime market, and the risks posed by predatory lenders.

Today's hearing we are going to look at the secondary market, the role that it plays in adding liquidity to the subprime lending industry, and the benefits it provides of expanded homeowner opportunities.

The nonprime market, I think the most surprising thing to me is the explosive growth in nonprime or subprime lending. In 1994, there were $34 billion in subprime mortgages. By 2002, that was $200 billion, so you are talking about a five-fold increase in 8 years in nonprime loans. A lot of this increase in the number of loans is because of development of the secondary market where the originators are selling loans into the secondary market, rather than retaining them in their own portfolios. When they do this, we found that they create mortgage pools and as a result of this there have been assignee liability problems, where people who purchase these mortgage pools are held liable as assignee's.

I think maybe that will be part of the focus at this hearing today, to determine the fairness of assignee liability provisions that require purchasers of mortgage pools to determine as part of their due diligence whether the lender or mortgage broker involved in originating the individual loans that make up the portfolio misrepresented loans terms or engaged in other deceptive practices in dealing with the borrower.

There is a question about the fairness of imposing liability on secondary market participants for violations, and I know we have

someone here from Standard & Poor's that is going to be a witness. They have simply refused to rate mortgage-backed securities if they contained non-prime or subprime loans because of what sometimes is described as vague or open-ended assignee liability standards that some States have imposed. As a result of the assignee liability question, Congressman Ney and Congressman Ken Lucas introduced H.R. 833. What it does is it contains consumer protections in disclosures. It is intended to serve as a uniform national standard for combating abusive and predatory lending.

At the same time, it addresses this assignee liability by amending the Homeownership Equity Protection Act. The approach that their legislation takes, I am sure the witnesses are familiar with that and will address whether they think that is the right approach. It at least has the possibility, if it is a fair approach, of establishing some legal certainty to the secondary market, which is lacking in a lot of State and local anti-predatory lending laws.

With that, I will just close. Thank you for having this hearing. I am convinced that nonprime loans allow many people to participate in homeownership or to purchase a home that would otherwise be unavailable to them. I would like to allow us to find a way to preserve this market, preserve this opportunity that many middle-and low-income citizens need to have homeownership, and at the same time establish some legal certainty in a fair way concerning assignee liability, and to do it in a way that is fair to all parties.

I yield back the balance of my time.

[The prepared statement of Hon. Spencer Bachus can be found on page 54 in the appendix.]

Chairman NEY. I want to thank the gentleman, and I thank the gentleman for chairing this hearing today with us.

The gentlelady from California.

Ms. WATERS. Thank you very much, Mr. Chairman.

I have a Statement that I am going to submit. I am here today to try and discover what the crisis is as indicated by this hearing. I think there is liquidity in the subprime market. I want to be clear. I am not opposed to subprime lending, and I know the difference between subprime lending and predatory lending. It does not have to be one and the same, but far too often it is. I am interested in making sure that in the subprime lending market, we do not have abusive practices, high interest rates and marketing techniques and practices that deceive and get people hooked into loans that they do not understand and cannot afford.

So I am very careful about making sure that that is understood; that subprime lending can be lending that can be helpful, but it is not always helpful and I think we find a disproportionate amount of the predatory lending in the subprime market. I am opposed to preemption. I do not know if you are aware that Los Angeles is one of the cities that has passed some local predatory lending laws. I want to be careful to do nothing that would preempt the kind of work that they are doing and some of the other states. I understand there are about 29 states and at least 18 municipalities that have enacted laws to address the problem of predatory lending.

So I am going to listen to the witnesses here today to see what they have to say. I do not know what the crisis is. Perhaps there

will be some information here that can help me to understand exactly what is meant by the subject of this hearing. So with that, Mr. Chairman, I am just going to yield back the balance of my time.

[The prepared statement of Hon. Maxine Waters can be found on page 65 in the appendix.]

Chairman NEY. I thank the gentlelady.

Chairman Baker.

Mr. BAKER. Thank you, Mr. Chairman, for your leadership and interest in this matter, as well, of course, as Chairman Bachus. I know both of you have had longstanding concerns about this market issue. I understand the focus of the hearing today is the potential causes of liquidity impairment and abusive practices that may occur in the subprime mortgage market. I certainly agree with your interest in need for review, however I just want to make a very narrow observation about a concern I have today, which is that mentioned by Mr. Bachus as well, the potential imposition of liability on assignee's of mortgage loans.

This imposition would, I think, place a burden on the secondary market participants that would affect and have a disruptive affect on the flow of legitimate credit to many underserved communities. The advent of securitization certainly has assisted in the liquidity of mortgage markets, lowered cost of credit, significantly increased the availability of subprime mortgage credit, and has resulted in benefits, not necessarily associated with that described as predatory lending. But the consequences of assignee liability would cause potential buyers to forego purchasing subprime or high-cost mortgage loans. Certainly if this were the case, with fewer buyers and less money, legitimate lenders would ultimately impair the ability of low-and moderate-income customers to participate in homeownership.

The public policy challenge, I believe, is to strike a balance between limiting abusive lending practices, while ensuring the flow of credit to borrowers who cannot obtain loans in the primary market. Consumers obviously need to be protected from unscrupulous lenders, particularly those who are financially unsophisticated. I do believe there are sufficiently strong standards currently in existence and they should continually be reviewed to determine their adequacy of protection of the unsophisticated borrower.

Extension of these sanctions, however, to assignee's risks the future of our current market structure. To assure that assignee's are not made liable for abuses they cannot reasonably discover and correct, I have been at work for some time drafting my own approach to a remedy and I will be introducing later this week, that would recognize that commercially reasonable responsible actions called due diligence, which would not enable discovery, ought to be a sufficient defense. Sanctions such as class action civil liability, loan rescission, are matters which should be discussed. Assignees should be allowed to take some time to take corrective actions upon appropriate discovery of a compliance failure.

These are I believe important issues deserving of the committee's time, and I look forward to working with you, Mr. Chairman and Mr. Bachus, over the coming weeks as we move forward in trying to provide balance in a very important market that provides a serv-

ice to many underserved consumers, and certainly a very important part of our overall economic recovery.

I thank you, Mr. Chairman.

Chairman NEY. I want to thank the gentleman.

Mr. Sanders, the gentleman from Vermont.

Mr. SANDERS. Thank you, Mr. Chairman. I thank you and Chairman Bachus for holding this important hearing.

According to the Center for Responsible Lending, predatory lending is costing American families $9.1 billion every year. I am happy that Michael Calhoun from the Center is here with us today to talk about that study.

Mr. Chairman, in the richest country on earth, there is something wrong when so many foreclosures are taking place. Between 1980 and 1999, both the number and the rate of home foreclosures in the United States have skyrocketed by 277 percent. According to an article in the New York Times, over 130,000 homes were foreclosed in the spring of 2002, with another 400,000 in the pipeline. Many of these foreclosures are a direct result of predatory lending practices in the subprime mortgage market that must be put an end to immediately. According to the Mortgage Bankers Association, while subprime lenders account for 10 percent of the mortgage lending market, they account for 60 percent of the foreclosures.

Mr. Chairman, the title of this hearing is Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market. That is a very interesting title. The title seems to assume that there is a lack of liquidity in the subprime market that is somehow depressing homeownership in this country. But Mr. Chairman, according to figures compiled by the National Mortgage News, new subprime loans totaled $290 billion in 2003, more than double the total loan volume for 2000.

Mr. Chairman, we have a subprime industry which has more than doubled their loan volume over the past 3 years, but accounts for 60 percent of all foreclosures in this country. I have to ask, by providing even more liquidity in the subprime market, would we be promoting homeownership or would be promoting foreclosures? Everyone wants to promote homeownership. Homeownership is the American Dream. But having your home taken away from you because you cannot pay the bills charged by predatory lenders can quickly turn the American Dream in to the American Nightmare.

Also in this discussion, importantly, let us not forget that predatory lending is being perpetrated by the likes of just not small-time operators, but by the likes of Citigroup and Household International. As a result of legal actions filed by the FTC, Citigroup agreed in September to reimburse consumers $215 million for predatory lending abuses which represents the largest consumer settlement in FTC history. Household International has agreed to pay $484 million to reimburse victims of predatory lending, representing the largest direct payment ever in a State or federal consumer case.

Mr. Chairman, when we are talking about predatory lending, we are not just talking about mortgage lending. Let us take finally a hard look at the abuse in credit cards, where many working people are paying 25, 28 percent a year in interest rates on credit cards,

and as a result are going even further into debt. In my view, that is predatory lending as well.

Lastly, Mr. Chairman, I know there is an effort to preempt states and localities from passing strong anti-predatory lending laws. Mr. Chairman, the Republican Party has got to get its act right. Either they hate the big bad federal government or they love the big bad federal government. You cannot have it both ways. You cannot tell us how we love local government and State government. The word, Mr. Chairman, is laboratories of democracy. That is what it usually is, something like that, and then we preempt them every single day. Let's get our act together. Either the Republican Party wants to be the spokesman for the big strong federal government taking away power from local government or not, but let's be a little bit consistent in that area.

I yield.

Chairman NEY. I want to thank the gentleman for his kind comments.

[Laughter.]

Mr. Miller?

Mr. GARY G. MILLER OF CALIFORNIA.Thank you, Mr. Chairman.

I want to commend you, Chairmen Ney and Bachus, for having this hearing. This is an extremely important issue in the subprime market out there. This is a very important issue particularly in the passage of State and local predatory lending laws which have assigned liability to the secondary market.

There is basically a housing crisis in this country, particularly in my State of California. The California homeownership rate is 56.9 percent in 2000. That lags the rest of the nation by over 10 percent. We also have the highest home prices in the nation. Housing finance is so vital to Americans and the overall health of our economy that the best public policy is for Congress to ensure that we have a fair workable uniform national lending standard. We must eliminate abusive lending practices, while preserving and promoting access to affordable housing credit.

There is no question that in some nonprime borrowers, they basically have been abused and we need to deal with abusive practices, but we should do everything we can at the same time to prevent them. There is also no question of the vast number of borrowers who are not victims of such practices can become victims by poorly crafted protective legislation that restricts nonprime credit availability and basically creates an unnecessary situation.

State and local anti-predatory lending laws are inconsistent and sometimes ineffective and nonexistent, and often arbitrary and unduly burdensome. This has been an effect of limiting nonprime credit availability. These laws have forced the mortgage industry to restrict access to credit or exit markets entirely. You cannot have a system whereby if you go one city, you have one requirement, and another city, you have another requirement. There is litigation on many of these ordinances that have passed locally that have not been implemented.

From what I am hearing, if they are implemented, that the impact is going to be disastrous to local economies. That is unfair. You should not be discriminated against because you want to buy a home in a certain area. If you are looking at the subprime mar-

ket, if you eliminate that, people are really in serious trouble when it comes to financing homes in those areas. So you have to be very cautious. You have to understand that there is a need for subprime and the predators in that marketplace need to be eliminated.

We need to do everything we can in this nation to give people an opportunity to own a home. It is becoming more and more difficult to provide housing for people in this nation as time goes on. We have to be proactive in this area. Sometimes you have to look at what happens at the local level. We do that in housing all the time. HUD is looking at eliminating local red tape that exists out there that precludes people from being able to build homes in certain areas. We have to be proactive in doing that. You cannot sit there and ignore local policies that are just absolutely abusive towards people wanting to buy homes.

You look at some of these areas, and the assessment against builders who want to build homes is so outrageous and generally passed on to homebuyers, that the federal government has to say this is wrong; that you are abusing people and perhaps federal policy has to establish certain guidelines that preclude some of these abusive policies. In subprime lending, we need to look at predatory. And when it is being abused, we need to move proactively

So Chairmen Ney and Bachus, I applaud both of you for your efforts on this and I look forward to hearing the testimony from our panel. I yield back.

[The prepared statement of Hon. Gary G. Miller can be found on page 63 in the appendix.]

Chairman NEY. I thank the gentleman.

The gentleman, Mr. Miller from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

I agree with those members who have said that it is vital that we make credit available for homeownership to those borrowers, those consumers who have less than perfect credit. It is also vital that they use the equity in their home, their life savings to provide against the contingencies of life. That is how they have saved for a rainy day.

But I strongly agree with those members who say that there are sufficient consumer protections now for what is happening to some of the most vulnerable consumers when they try to borrow money against the equity in their home to provide for life's rainy days. There is outrageous conduct going on. In the words of Woody Guthrie, they are being robbed with a fountain pen. There are lenders who steal their life savings, the equity in their homes, from the most vulnerable of consumers in the most difficult of circumstances. I certainly think that we can strike a balance between making credit available to those in that subprime market, including a liquid secondary market, and providing reasonable protections to those consumers.

It is true that Standard & Poor's have said that the subprime loans coming out of some States require additional credit enhancements. North Carolina was the first State, and it is not our nature to be first in anything; we were the 12th of the 13 states to ratify the Constitution; I think we were among the last of the States to join the Confederacy. We did ratify the constitutional amendment guaranteeing women the right to vote. I think we did that in the

1980s. But we were the first with this, and our statute has held up pretty well.

There is readily available credit for the subprime market. Standard & Poor's has said that there is no enhancement required for North Carolina's subprime loans. I think it is perfectly possible to craft legislation here that will protect consumers against those outrageous practices that are occurring, and assure the continuous availability of credit.

I join Mr. Miller, the other Mr. Miller, in his opposition to poorly crafted legislation. I strongly oppose poorly crafted legislation. I may put that on my campaign literature this year. I am strongly opposed to poorly crafted legislation. But it is simply the case that we have legislation arising from the States that show us what can work.

Thank you, Mr. Chairman.

Chairman NEY. Mr. Royce.

Mr. ROYCE. Thank you, Chairman Ney. I would like to thank you, Mr. Chairman and Chairman Bachus for holding this very timely hearing on issues in the secondary mortgage market. I would like to also thank our distinguished witnesses for appearing today.

I think it goes without saying that the housing economy has been quite resilient for a number of years. I think this strength has occurred because of a number of factors, but one is asset allocation away from equities. Certainly, friendly government policies have helped, and low interest rates.

What concerns me is that problems in a sector can often be hidden or overcome in a boom cycle. All of that being said, I think that we need to start thinking about what happens when that housing market cools, because today we have Fed funds rate at 1 percent, but if we believe Wall Street economists, they say that the Fed fund rate will reach 4 percent by the end of 2005. If these predictions prove true, unless we have a very flat or inverted yield curve, mortgage rates are going to be much higher in the not too distant future. Higher interest rates are going to have a very adverse impact on the housing market.

I do not know how much we can do about that possibility, but we can address structural issues that unnecessarily add costs to consumer mortgages. In my view, assignee liability is one issue that we should address. Congress should encourage more investment in the secondary mortgage market. Assignee liability provisions do just the opposite. Fixed income investors are not excited to become the next target for trial lawyers, and that is a big problem here in the United States. Until we act, billions of dollars of capital investment will likely stay away from the subprime market. That is going to harm the very people assignee liability laws are intended to help.

So once again, I thank Chairman Ney and I thank Chairman Bachus for having this hearing today, and I look forward to working with my colleagues on this very important issue. I yield back, Mr. Chairman.

Chairman NEY. I want to thank the gentleman.

The gentleman, Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman.

I, too, am very much looking forward to this hearing. As the Congressman from Georgia who was very much involved in the predatory lending legislation in the State, going all the way back to the beginning with the Fleet Finance fiasco, our State has been a major player in this debacle.

I have heard from some representatives from the mortgage industry that subprime lending provides homeowner opportunities for many individuals who normally would not qualify for prime loans. I have also heard from consumer advocates that subprime mortgage lending provides ample opportunity for predatory lending practices and gives incentives to liberally approve loans to individuals who cannot afford a loan. Advocates from consumer advocates and subprime lenders both would like to see the creation of a national predatory lending law, and I certainly commend the leadership of our financial services committee for moving in that direction.

As a former member of the Georgia General Assembly as a State Senator, I can speak of the impact that an overly strong regulatory measure can have on a housing market. For a little bit of history, the Georgia Fair Lending Act had several provisions, including assigning liability to secondary markets, which caused financial companies to pull out of our State and withdraw some lending products. The Georgia legislature had to revisit the law last year to prevent additional companies from leaving the State.

In an effort to stop unscrupulous lending practices, the Fair Lending Act caused hardship to legitimate lenders. It triggered an immediate reaction from both mortgage lenders and secondary market entities. Once that Act extended assignee liability to potentially thousands of covered loans, with interest rates approximately 4 percentage points below the HOEPA interest trigger. Major mortgage lenders announced their plans to stop making both the high-cost loans and cover loans in Georgia. Standard & Poor's announced it would not rate mortgages covered by the law, and both Fannie Mae and Freddie Mac indicated they would not purchase mortgages that qualify as high-cost loans under the Act.

Assignee liability, then, presents us with quite a challenge. The central question, of course, is what is the effect of making assignee liability for the predatory lending practice of originators? Should assignee's be required to bear the responsibility for the predatory practices of those from whom they purchase loans?

One side of the argument is that it is clear that if the liability is broad and does not provide solid safe harbors and limits on liabilities, lenders will refrain from purchasing a broad category of loans. This is because the risk of acquiring the loan has become too great, not because of each of the loans in that category may be predatory. This means that many lenders will not originate high-cost loans and purchasers will not purchase them. They will not be securitized and the secondary market will not produce the liquidity that fuels additional lending in the high-cost loan market.

Yet, assignee liability is critical to successful efforts to address predatory lending. It helps to protect responsible investors from misperceived risk and provides incentives for the market to police itself, curbing market inefficiencies. The argument is, without assignee liability an unscrupulous lender can increase the value of

the loans it sells by engaging in predatory practices, and packing the loan with unnecessary fees, excessive interest rates and large prepayment penalties. The lack of assignee liability provides little incentives to purchasers of such loans to determine if the loans were originated illegally or are so out of line with market norms that they present a substantial likelihood of abuse.

What a dilemma; what an issue. How do we resolve it? How do we get an end to predatory lending? That is on our plate today and I look forward to an excellent meal.

Thank you.

Chairman NEY. I want to thank the gentleman.

Mr. Hensarling from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman, and thank you and Chairman Bachus for holding this hearing.

Since coming to Congress, I have heard a lot of bad ideas, but assigning strict liability to assignee's of mortgages in the secondary market—strict liability—strikes me as one of the worse. I mean, where those who purchase the mortgage do not even have any knowledge of a potential underlying violation strikes me as a truly, truly bad idea.

One thing we have consensus on in this committee is that we all believe that predatory lending is a problem. Unfortunately, we cannot seem to come to any consensus on what predatory lending is or is not. I hope that we as a committee do not conclude that predatory lending is tantamount to a commercial transaction between consenting adults with full disclosure, but because we do not like the terms, we decide in our infinite wisdom that we should outlaw these transactions.

Now, as we debated the Fair Credit Reporting Act, we heard testimony after testimony that we in America enjoy the most accessible, lowest-cost credit in the world. I think it is undisputed we have the highest rate of homeownership in the entire history of our nation, and that includes homeownership opportunities for low-income individuals and those who have either poor credit records or no credit records.

If we do not legislate properly, we risk all of this. I certainly found the comments from my colleague Mr. Scott of Georgia very instructional, very enlightening. To some extent, it seems to me we have a case study of what happened in Georgia and I look forward to hearing some testimony from the witnesses on this. But what I saw happen in Georgia was that Ameriquest, Chase, City Financial, Fannie Mae, GMAC, National City, Option One, Freddie Mac, Wachovia, the list goes on and on and on, all pulled out of the market because of uncertainties with respect to the liability.

If we want to be pro-consumer on this committee, I would suggest that we work hard to make sure that we increase market competitiveness and not sow the seeds of the market's destruction. It is critical that we figure out what predatory lending is, that we agree on the definition and we isolate it from those reasonable players in the commercial market who are making homeownership opportunities available to low-income Americans.

I yield back the balance of my time.

Chairman NEY. The gentlelady from New York, Ms. Velazquez.

Ms. VELAZQUEZ. I ask that my statement be included in the record.

Chairman NEY. The gentlelady asks for unanimous consent. I would note for all members, unanimous consent if there is no objection for their statements to be entered into the record.

Mr. Lucas.

[The prepared statement of Hon. Nydia M. Velázquez can be found on page 64 in the appendix.]

Mr. LUCAS. Mr. Chairman, in the interest of time, I would like to associate myself with the remarks of my colleagues across the aisle, Mr. Miller of California and Mr. Royce, and also with Mr. Scott of Georgia. Thank you.

Chairman NEY. I thank the gentleman.

The gentleman, Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman.

Just very briefly, first of all, I thank you for holding the hearing today. I think for both sides of the aisle, we are concerned about the same thing, and that is the victims, whether they be defined as some us are concerned, the victims of abusive practices, or also those people who are the victims of good intentions.

I come from the State of New Jersey where the victims in that case are the victims of good intentions of the State legislature who, as in Georgia as well, had the best of intentions, I am sure, to look after those folks who may be victims of abusive lending practices. But at the end of it, they become victims themselves, whether they are those who no longer are able to enter into the subprime market, the families involved who are no longer able to get those loans; and finally those legitimate lenders who are now precluded from being in that marketplace because of the actions that the State legislature took.

I am also mindful of the Ranking Member's comment at the outset of these discussions with regard to a Statement saying we have to get our act together here. Would that be true, that we get there, and make a decision from either side of the aisle as to where the appropriate responsibility lies, whether it is on these areas of State concern or federal concern.

I think at the end of the day, the hearings that we hold here at the very least should shine the light of day both on the abusive practices, but also on the very debilitating effect that the State legislative actions in several States have already taken, and fortunately they have begun to take remedial actions on these various facets.

Mr. Chairman, again I appreciate your holding these hearings and I yield back the balance of my time.

Chairman NEY. Thank you.

The gentleman from New York, Mr. Israel.

Mr. ISRAEL. Thank you, Mr. Chairman.

I will take less than a minute. There is an old saying here in Washington that we cannot define pornography, but we know it when we see it. The same rule cannot be applied to predatory lending and below-prime lending. It clearly means different things to different people. I have a community in my congressional district that has been tragically undermined by predatory lenders. The fact

of the matter is that bad actors in predatory lending are negatively defining reputable below-prime lenders.

I have a very simple bottom line, Mr. Chairman, and that is that I believe that we need to work on a bipartisan basis to create an appropriately regulated federal marketplace that allows the subprime industry to give more people access to homeownership, while completely shutting down the bad actors. I look forward to working with my colleagues towards that end.

Thank you, Mr. Chairman. I yield back.

Chairman NEY. Thank you.

Mr. Davis of Alabama.

Mr. DAVIS. Thank you, Mr. Chairman. Let me also thank the Ranking Member for her comments at the beginning.

I will not take anywhere near the full 5 minutes, but I want to define the problem from my perspective. On both sides of the aisle, we have a very strong commitment to a free market in this country. That is a bipartisan commitment that we have. The challenge of predatory lending and excessive subprime lending is that it distorts the market. I have to consider a market to be distorted when upper-income African Americans and upper-income Hispanic Americans with good credit are finding themselves pushed into the subprime market. That is a distortion of the way the market should be working in this country. It is a distortion that limits homeownership opportunities. It is a distortion that locks people into a vise from which they often cannot escape.

We are struggling for a solution. I think a number of us would like to see a national standard, but it has to be a national standard that has some teeth to it. It is a reality that the efforts of the Department of Treasury, the efforts of the Office of Comptroller of the Currency have frankly not made any real headway. One of the reasons why some of us on this side of the aisle are troubled by the OCC's efforts at preemption several months ago is because the efforts of HUD, the efforts of OCC in the last several years have not made any significant dent, as Chairman Bachus said at the outset, in the incidence of subprime lending. I think illegitimate subprime lending is only continuing to rise in this country.

The short of it is that we have to find a strategy to address this serious market distortion and we have to rise above anecdote. What we often hear is that, well, we have made progress in Baltimore; we have made progress in L.A.; we have made progress in New York. Nobody ever wants to quantify this problem. Nobody wants to find a way to really, number one, identify what practices are illegitimate lending and what we can do about it.

So I hope the focus of this hearing will lead us toward some consensus on what an across-the-board approach ought to look like, but I hope that we do not leave here without a genuine recognition that this is a market distortion and it is something that ought to concern both sides of the aisle.

I yield back the balance of my time.

Chairman NEY. I thank the gentleman.

With that, I want to thank also the witnesses and the members for their opening statements. We will move on to the panel. Our first witness is Micah Green, who is president of the Bond Market Association, an association representing approximately 220 securi-

ties firms and banks that underwrite, trade and sell debt securities. Mr. Green joined the association in 1987, having previously served as the staff director and general counsel with the House Subcommittee on Human Resources of the Committee on Post Office and Civil Service.

Frank Raiter is a managing director of Standard & Poor's Credit Market Services, a division of the McGraw-Hill Companies. The company assigns credit ratings to financial institutions such as loan guarantees, bank loans and mortgage-and asset-backed securities.

I will defer at this point to Mr. Miller of North Carolina to introduce the next witness.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. I am very pleased to introduce Mike Calhoun to this committee. Mr. Calhoun is the general counsel and vice president of the Center for Responsible Lending. They are headquartered in Durham, which adjoins my district, and I believe Mr. Calhoun lives in Durham as well. The Center for Responsible Lending is an affiliate of Self-Help, and Mr. Calhoun is also a general counsel of Self-Help.

I am very proud of the work that Self-Help has done in making credit available, providing financial services generally to low-income consumers, and has done it on reasonable terms. Their approach is, how to provide a product at a reasonable price, taking risk into account, and make a fair, reasonable profit off of the transaction, as opposed to when a consumer walks in their offices, taking the approach of just how much money can we they make off that consumer. Self-Help has grown dramatically and has done great things for folks in North Carolina.

Mr. Calhoun has practiced consumer law for more than 25 years. He is a graduate of the law school at the University of North Carolina at Chapel Hill, an outstanding academic institution. I understand that Mr. Calhoun also has a college degree.

Chairman NEY. Thank you.

The next witness is Pamela Kogut, who is the Assistant Attorney General in the Office of Massachusetts Attorney General Thomas F. Reilly; and Richard DeMong is the Virginia Bankers professor of bank management at the McIntire School of Commerce at the University of Virginia, where he taught since 1977. Dr. DeMong is a registered investment adviser and has lectured extensively on issues relating to equity evaluation of subprime loans and financial analysis.

I want to welcome all the witnesses today. We will start with Mr. Green.

STATEMENT OF MICAH S. GREEN, PRESIDENT, THE BOND MARKET ASSOCIATION

Mr. GREEN. Thank you very much, Chairman Ney. I really appreciate your kind introduction. I congratulate you and Chairman Bachus and Ranking Members Waters and Sanders for your leadership and continuing your review of this important issue. I also would thank Chairman Baker for his constructive work on this issue.

Let me just say, too, to the entire subcommittees, I know typically a hearing is when those of us who are witnesses impale our-

selves to you about what we think needs to be done. I will tell you, I just sat through 20 opening statements of people who have thought about this issue, people who understand this issue, people who have strong feelings on this issue. We have heard from you. I think I can speak for my other panelists. We know what we have to do now. We know that we have to be responsible on this issue. We cannot understate the problem of predatory lending, nor should we overstate the market issues.

We also need to be very careful to be very clear about what the problem is with assignee liability, and we need to make sure that we fully understand and together define clearly what a good subprime marketplace is all about and what bad predatory lending is all about, and agree that we have to stop predatory lending, but not at the cost of people who need access to capital just merely because they have had a tough lot in recent years and their credit rating may not be stellar.

So I will tell you as a witness at this hearing, I have heard your Statements and I will take them back to our community to make sure that we take the charge very seriously, to come together constructively on something that can hopefully advance the ball here.

But there is a problem. There is a problem, and to pick up on Congressman Sanders's point about the States being a laboratory the States have, in fact, been a laboratory. The States have been an excellent laboratory. States have tried to deal with this issue in ways they sincerely knew and felt that they could best deal with this issue. And they learned that there was a problem. There was a problem that if you go too far, it can have a cost to people who need legitimate capital at the most affordable cost.

Keep in mind, all these statistics about the growth of the subprime market have been at a time when interest rates have been very low. The subprime market has grown just as the other mortgage market has grown tremendously, both the refinancing market and the original issue market for home purchases. We are about to enter a period of rising interest rates. We are also about to enter a period where people who may have been out of work during a recession may be coming back to work. What happens when people are out of work? Their credit rating, their own personal credit quality could go down during that period of stress in their life.

So they may now be back at work and need to access capital for the purchase of a home or for whatever reason, and because of a blemish on their record may need to access the subprime market at the most affordable level. If a viable secondary market is not working well to help reduce the cost of that subprime marketplace, real people will be hurt, not by a loss of liquidity, which is a favorite term of art in the marketplace, but by higher costs. The way liquidity translates itself to the average person is a higher cost of that borrowing, a higher cost of that mortgage. So we are at a time where this issue has grown in importance because of a potential rising interest rate environment, as Congressman Royce indicated.

But I will say that the real problem with the laboratory experiment in the States has been not only any one particular state experience, like what happened in Georgia or New Jersey or any one of numerous states, but the fact that we have a patchwork quilt of

various types of state regulations and state requirements. Some of them are clear and objective. Some of them are vague and uncertain.

The marketplace is a national marketplace. In order to quantify the risks, you need clarity and objectivity. Imprecision and unclearness results in the inability to value those risks and quantify those risks. That is why when a very objective observer like S&P looks at this issue, they say it is difficult for them to quantify the credit-worthiness, as you will hear from S&P.

So we come here today wanting to be a partner. We want to work with these committees to try to arrive at a solution. In a perfect world, no assignee liability would probably be the ideal, but we recognize, as Congressman Scott said, that you need some way to enforce these rules in a way that will get at the predatory lender. So we would support clear objective assignee liability, because at the end of the day if it is clear and objective, it can be implemented in a precise and less costly way.

So we would look forward to working with this committee to try to figure out where that line is, but clearly the status quo, particularly at this stage of the market cycle, is not a good place to be.

So I thank you, Mr. Chairman and members of the committee, and I look forward to answering your questions.

[The prepared statement of Micah S. Green can be found on page 98 in the appendix.]

Chairman NEY. I thank the gentleman.

Mr. Raiter.

STATEMENT OF FRANK RAITER, MANAGING DIRECTOR, STANDARD & POOR'S CREDIT MARKET SERVICES

Mr. RAITER. Good morning, Chairman Ney, Chairman Bachus and members of the subcommittees.

As an independent and objective commentator on credit risks, Standard & Poor's generally does not take a position on questions of public policy. Thus, while Standard & Poor's strongly supports efforts to combat predatory lending and other abusive practices by lenders, it does not take a position on what legislative or regulatory actions would best accomplish that goal.

Nevertheless, Standard & Poor's has been closely following legislative and regulatory initiatives designed to combat predatory lending in order to determine how those laws might affect its ability to rate securities backed by residential mortgage loans. Standard & Poor's appreciates the opportunity to discuss the factors that it considers when evaluating the impact of anti-predatory lending laws on rated transactions and in particular the issue of assignee liability.

Increased access to mortgage loans has led to increased homeownership across the United States. While this growth in homeownership is positive, it has become evident that some of this increase has unfortunately occurred simultaneously with the rise in predatory lending practices. Among others, these predatory practices include the following: charging excessive interest or fees; making a loan to a borrower that is beyond the borrower's financial ability to repay; charging excessive prepayment penalties; encour-

aging a borrower to refinance a loan notwithstanding the lack of benefit to the borrower; and increasing rates upon default.

Anti-predatory lending laws are designed to protect borrowers from these unfair, abusive and deceptive lending practices, and Standard & Poor's strongly supports efforts to eliminate predatory lending. However, in its role as a provider of opinions on credit risk, Standard and Poor's must evaluate the impact of these laws on the return to investors in mortgage-backed securities.

Indeed, given the expansion of individual investment in securities through various retirement and pension plans, these investors might actually be the same borrowers the laws are intended to protect. Standard & Poor's has determined that some of these laws may have the negative affect of reducing the availability of funds to pay these investors. This reduction could occur if an anti-predatory lending law imposes liabilities on purchasers or assignee's of mortgage loans simply because they hold the loans that violate a law, even if they did not themselves engage in predatory lending practices.

In performing its evaluation of anti-predatory lending laws, the two most important factors that Standard & Poor's considers are whether an anti-predatory lending law provides for this assignee liability, and if so what penalties the law imposes on assignee's for holding predatory loans. If Standard & Poor's determines that there is no assignee liability, Standard & Poor's will generally permit loans covered by the law to be included in rated transactions without any further considerations or restrictions.

If on the other hand, a law does permit assignee liability, Standard & Poor's will evaluate the penalties under the law. If damages imposed on purchasers are not limited to a determinable dollar amount, that is the damages are not capped, Standard & Poor's will not be able to size the potential liability into its credit analysis. Therefore, these loans cannot be included in rated transactions.

If on the other hand, monetary damages are capped, Standard & Poor's will be able to size in its credit analysis the potential monetary impact of violations of the law. Standard & Poor's looks at all types of potential monetary damages, including statutory, actual, and punitive damages. It should be noted, however, that even if capped damages can be sized, it may not be economical for a lender to make such loans if the credit support that Standard & Poor's would require equals or exceeds the monetary value of the loan. For example, if a law provides for punitive damages, even if these damages are capped, the amount of the damages may well exceed the loan value.

In making these determinations, above all Standard & Poor's looks for clarity in the law. Specifically, Standard & Poor's looks for statutory language that clearly sets forth what constitutes a violation, which parties may be liable under the law, and as noted, whether any monetary liability is limited to a determinable dollar amount. Absent clarity on these issues, in order to best protect investors in rated securities, Standard & Poor's may adopt a conservative interpretation of an anti-predatory lending law and may, in instances where liability is not clearly limited, exclude mortgage loans from transactions it rates.

In offering these comments today, Standard & Poor's reiterates to the honorable members of the subcommittee that as a public policy matter, Standard & Poor's supports legislation that attempts to curb predatory and abusive lending practices. Standard & Poor's also notes, however, that its role is to evaluate the credit risk to investors associated with anti-predatory lending legislation, and not to recommend public policy.

This concludes my testimony. I will be happy to answer any questions. Thank you.

[The prepared statement of Frank Raiter can be found on page 111 in the appendix.]

Mr. BACHUS. [Presiding.] Mr. Calhoun.

STATEMENT OF MICHAEL D. CALHOUN, GENERAL COUNSEL, CENTER FOR RESPONSIBLE LENDING

Mr. CALHOUN. Chairmen and members of the committee, I appreciate the opportunity to testify today, and I thank Congressman Miller for his kind introduction and his respect for his college rival, Duke University.

Self-Help has provided over $3 billion of financing for first-time homebuyers across this country. We regularly purchase, securitize and hold loans in the secondary market. Our mission is to help families create financial net worth. In the late 1990s, we found that many of our borrowers that we had helped put into homes were being solicited to refinance into predatory loans. We also found that many loan applicants had already been trapped in predatory loans and were unable to qualify for a loan to help them.

We and other lenders and many other groups worked together in 1999 when North Carolina enacted the country's first predatory lending law. It has worked very well both protecting consumers and maintaining access to credit. I was one of the principal drafters of the law and I also serve as general counsel for Self-Help in its lending programs, and have previously directed Self-Help's secondary market program.

I will address three points this morning. First, assignee liability is presently a part of our national mortgage market and a necessary part. It is not something new. Second, the North Carolina law which has substantial assignee liability has worked very well. And finally, I will address the impact of the subprime market on homeownership.

Today, it is a fact that most home loans are sold. You end up making your payments to somebody totally different from whomever you took the loan out with. Assignee liability simply means if the loan is illegal, can those violations of law be enforced against the party collecting or even foreclosing on your loan?

Assignee liability is commonplace in mortgage transactions presently under a number of State and federal laws. It is the general rule in many consumer transactions, such as car purchases, furniture purchases that are regularly securitized, that paper is securitized. At the most critical point, with a family facing the threat of foreclosure, the absence of assignee liability means that the purchaser of the illegal loan can foreclose and evict the family and force them to try and find the original lender and seek redress against a party that may be gone or bankrupt. We will hear exam-

ples of that today from other witnesses. In short, significant assignee liability is central to protect families and protect the integrity of our mortgage market.

The North Carolina law did not contain a separate assignee liability provision because assignee liability for certain mortgage violations was already part of existing North Carolina law. North Carolina's subprime market has remained strong, growing more than 50 percent under the law. A UNC Business School study of the law's impact found no reduction in subprime home purchase loans in North Carolina under the law. It found the effect on refinancing loans was overwhelming on those loans with predatory features. It concluded the law was having its precise purpose and was working well. New Jersey and several other States have even more limited assignee liability than North Carolina and we expect that there will be positive experiences there as well.

As noted by the Chairman and several other members, the subprime market has been exploding in volume. It is important to remember, though, the subprime market when we look at its impact on homeownership is overwhelmingly a refinance market. Over three-fourths of these loans are refinancings of existing mortgages where somebody is already in a home, not loans to purchase a home. Foreclosure in the subprime market, as noted, is exploding at a rate 10 times that of the prime market. As we sit here today, fully 5 percent of all subprime loans are in foreclosure right now.

Moreover, these loans tend to refinance repeatedly and have an average life of only 3 to 4 years. If a lender charges five up-front points or more and/or a 5 percent prepayment penalty, with each loan and each refinancing, quickly a family's long-earned home equity is gone. This has a very disparate impact on minority families. While the reasons can be debated, it is a fact that minority families are much more likely to have and be affected by subprime loans than other families.

Moreover, the loss of home equity is even more devastating. There is a tremendous equity gap in the United States today, with African American families having only one-tenth the net median wealth of majority families. That is currently about $10,000.

The continuation of unchecked predatory loan practices gravely threatens homeownership and equity of families. I urge this committee to enact effective federal protections like those in North Carolina. These federal protections should be a floor, not a ceiling so that the States and Congress can work together to protect American families.

Thank you.

[The prepared statement of Michael D. Calhoun can be found on page 67 in the appendix.]

Mr. BACHUS. I appreciate that.

Assistant Attorney General Kogut.

STATEMENT OF PAMELA KOGUT, ASSISTANT ATTORNEY GENERAL, OFFICE OF THE ATTORNEY GENERAL, COMMONWEALTH OF MASSACHUSETTS

Ms. KOGUT. Thank you, Mr. Chairman and members of this committee. I am so pleased to be here today to present the views of Massachusetts Attorney General Tom Reilly and our office's work

concerning subprime mortgage lending cases. I bring to this hearing the perspective of a law enforcement office which has a long history of bringing cases against mortgage lenders that have engaged in unlawful practices, including cases against subprime mortgage lenders.

I am going to highlight a recent case which our office brought against, First Alliance Mortgage Company. This case illustrates that even when we have reasonably strong consumer protection laws on the books, in straightforward egregious violations of the law, consumers may not be made whole by a lawsuit at the end of the day unless the laws are made stronger and the secondary market entities are held accountable. If the secondary market entities are not held accountable, at the end of the day the consumers are going to be left holding the bag, and the bag will be empty. That is what our experience has shown us.

So to focus on the First Alliance Mortgage Company case, this Irvine, California-based lender obtained a license from our Division of Banks to do business in Massachusetts in 1997. After a routine examination a year into their license, our Division of Banks found that this lender was routinely charging borrowers 20 points and more for mortgage loans. Our Division of Banks was concerned and referred the matter to our office for enforcement. We filed a lawsuit fairly soon after the case was referred to us. We filed a lawsuit in October of 1998. We focused on a State regulation that prohibits mortgage lenders from making mortgage loans with terms which significantly deviate from industry-wide standards or which are otherwise unconscionable.

The focus of the lawsuit was intended to focus really cleanly and swiftly on the points overcharges which were clearly unconscionable by Massachusetts standards. We expected that this was a lawsuit that would be wrapped up quickly. This turned out not to be the case at all. A little more than a year-and-a-half after the case was brought, First Alliance Mortgage Company filed for bankruptcy protection in California, which extended the litigation in our case by years. The case did not end up getting resolved until 2002. At the end of the bankruptcy case, the Massachusetts consumer saw only cents on the dollar.

Here is what we learned about First Alliance Mortgage Company's practices. During the year when they made loans in Massachusetts, and after we filed our lawsuit and obtained a preliminary injunction against first alliance which limited them to charging no more than five points per loan, they closed up shop in Massachusetts and left. So they only did business in Massachusetts for one year, making 299 loans. Of these, more than 35 percent of the loans contained points charges in excess of 20; two of our borrowers paid more than 30 points.

Although First Alliance characterized itself as a subprime lender, of the 299 loans made, 20 percent were made to borrowers whose credit ratings were A or A-minus according to FAMCO's own standards. What does this mean in practice? This means that for example one of our borrowers, a woman aged 61, borrowed the sum of $47,000, a little more than that. She had an adjustable rate note that had an initial rate of interest of 9.49 percent, and she paid more than 25 points, or more than $11,000 in points for her loan,

but she was rated as an A borrower, that is, a consumer whose credit history and debt-to-income ratio should have qualified her for a conventional conforming mortgage loan with competitive rates and costs. She was a middle-class borrower who lived in a good community outside of Boston, and she paid more than 25 points for a mortgage loan.

Twenty-eight of our borrowers had their loans flipped which means that within about a year after they obtained their original refinanced loan from FAMCO, they got another FAMCO loan and paid the same level of points the second time around. For example, one couple in their 60s paid more than $15,000 in points, or as it turned out, more than 20 points for the first loan they got with First Alliance Mortgage Company, and just 14 months later got a second loan from First Alliance Mortgage Company and were required to pay more than $15,000 in points the second time around. There is no reason for that level of points payment, obviously.

We learned that FAMCO telemarketers were taught to urge consumers to get new FAMCO loans at every opportunity. So if a consumer called this mortgage lender to get a loan payoff figure, the telemarketers tried to sell them a new loan. If they were late making one payment, telemarketers tried to get them to get a new FAMCO loan. Our Massachusetts consumers did not seek out this lender. They were solicited. They ended up with this loan not having needed it or looked for it in the first place.

We also learned that this lender got its loan originators to memorize and follow a deceptive sales pitch called the loan officer track. Without going into the details, this was basically a handbook on deception and specifically taught the loan originators to deflect questions about points charges. We learned that this lender did not hire experienced mortgage loan originators. They drew from car sales people who had proven track records in car sales. It is significantly that they were not taught about mortgage lending laws when they were trained. They were only taught to memorize this deceptive program.

Ultimately, after First Alliance filed for bankruptcy protection, the Massachusetts AG's office was joined by a number of other AG offices, Minnesota, Illinois, Florida, California and Arizona, and the New York State Banking Department, as well as the FTC and private class actions, and we worked in a coordinated fashion to get a result in bankruptcy court. The result was very good: 18,000 borrowers got consumer redress. The consumer redress fund was ultimately approximately $85 million, but still this was not enough money to go around at the end of the day. Massachusetts at the time that this lawsuit was filed did not have assignee liability and the First Alliance Mortgage Company entity did not have enough money at the end of the day to make our consumers whole.

One last point is that the coordinated plaintiffs in this case did make an important decision to sue Lehman Brothers, the investment firm that had securitized FAMCO's loans and a jury did fine Lehman Brothers was liable for aiding and abetting FAMCO in its fraudulent scheme, and was ordered to pay the sum of $5.1 million.

The point that we come here to make is that this is a lender that engaged in egregious violations of law. We had a clear law in Massachusetts, but we did not have assignee liability. The secondary

market entities did not contribute sufficiently and consumers were not made whole. Our consumers at the end of the day were seriously harmed and there was nothing we could do to protect them.

Thank you.

[The prepared statement of Pamela Kogut can be found on page 104 in the appendix.]

Mr. BACHUS. Thank you.

Professor DeMong.

STATEMENT OF RICHARD F. DEMONG, VIRGINIA BANKERS PROFESSOR OF BANK MANAGEMENT, MCINTIRE SCHOOL OF COMMERCE, UNIVERSITY OF VIRGINIA

Mr. DEMONG. Thank you, Mr. Chairman and members.

The nonprime mortgage lending has increased dramatically in recent years, providing billions of relatively low-cost loans to millions of borrowers whose risk profiles prevent them from qualifying for so-called "conventional" or "prime" loans that offer somewhat lower rates. Without the availability of nonprime loans, most of these borrowers would not be able to obtain credit to buy a home or to utilize some of their home equity for a variety of important financial needs.

The continued availability of critically important consumer credit is highly dependent on retaining a healthy and efficient securitization market for nonprime mortgages. Liquidity can be lessened significantly, especially for higher-risk borrowers, by unclear, overly restrictive and conflicting laws, particularly when purchasers or assignee's of nonprime loans are subjected to broad liability for errors that may have been made by loan originators While it is now generally recognized that additional legislative safeguards are needed to protect nonprime borrowers from certain potentially abusive lending practices, it is critical that such legislation does not have the effect of reducing credit availability.

This is an extremely important issue for millions of Americans, and I therefore commend Chairman Ney and Chairman Bachus for their continued leadership in scheduling this hearing to help address it. I also commend Representative Baker, who has voiced special concerns over preserving nonprime lenders's access to the capital markets, and Representatives Lucas, Watt, Miller, Kanjorski and others for seeking to develop workable legislative proposals.

The origination of nonprime mortgages in 2003 was estimated to be $325 billion, representing about 10.5 percent of all mortgage originations. Just as is true with the prime mortgage market, the nonprime mortgage market has become national as the large national institutional lenders have replaced banks and small finance companies as the primary source of funds.

Loan originators no longer need to hold a mortgage loan until maturity or sell whole loans to other financial institutions. With the development of the mortgage securities and an active secondary markets, lenders can sell entire pools of loans to a diverse set of investors such as pension funds, mutual funds, life insurance companies or individuals. By bringing new investors to the market, securitization has dramatically increased funding for housing finance, reduced margins, lowered costs and interest rates, and in-

creased access to credit across the country. Two-thirds of nonprime mortgage loans are now securitized in the secondary market.

To be most efficient, investors that are the source of funding for mortgage debt desire reliable risk analysis of the potential borrower, good reputations of all those involved in the mortgage lending process, transparency of the process, standardization of the process, and clarity in the laws.

Just as prime mortgage interest rate spreads dropped in the 1980s after the development of securitization, as well as the continued active secondary market, so have nonprime interest rate spreads dropped over the last 6 years, especially during the last 2 years. I have two exhibits. Exhibit one shows the subprime interest rate spread between nonprime loans and the 10-year constant maturity treasury rate, and you see the dramatic drop in the last 2 years. The second chart shows the difference between B credit and the 30-year FHA-insured FRM, the fixed-rate mortgage. Both of them show the shrinking spreads.

As economic theory suggests, nonprime interest rate margins for the lenders have decreased with growing efficiency, which partially came from the standardization, and competitiveness in the market. Borrowing rates have therefore decreased for consumers.

The investors evaluate all investments on a risk-adjusted basis. If an investment becomes uncertain or risky, investors will find other more certain and less risky investments. They demand a higher return for increased risks. All the financial markets crave certainty and similarity. A law that is not clear or certain may cause nonprime market liquidity to drop dramatically. An example of that is a study that I did in New Jersey after it implemented the New Jersey Home Ownership and Security Act of 2002, for the 2 months after the implementation of the law, as compared to the 2 months prior to it. Lending to subprimes dropped by over 60 percent. Any vagueness in the law will disrupt funding sources.

So as Congress evaluates a uniform nonprime lending standard, there are lessons from the development of the prime mortgage securitizaton market. The success of the conforming securitization market depends on standardization of the legal framework, including preemption of state usury laws; and predictable and limited risks for the ultimate investors in the securities, in other words, no broad assignee liability.

In closing, I urge Congress to pass a well-crafted federal law that prevents undesirable lending practices, while at the same time preventing disruptions to nonprime lending. That is, a law with clear, reasonable, and objective uniform national standards to prevent improper lending practices, and one that does not impose broad liability on assignee's. Such a federal law will not only protect borrowers, but will help promote continued liquidity in the nonprime mortgage lending market

Thank you for this opportunity to testify. I would be pleased to respond to any questions members may have.

[The prepared statement of Richard F. DeMong can be found on page 90 in the appendix.]

Mr. BACHUS. I thank the witnesses. For the record, without objection your entire written, statement, prepared statement will be made a part of the record.

The committee has established a procedure where members are called on to question the witnesses in the order that they arrived at the hearing. Therefore, Mr. Garrett is the first member to be recognized.

Mr. GARRETT. Thank you, Mr. Chairman.

Just a couple of questions, first, in line with the most recent testimony from the professor, can you delve into a little bit more with my home state, New Jersey, your findings after the two-month period, and were you able to do anytime after that? Because as you have heard testimony here and elsewhere, there is no impact, and the impact has only been a negligible one or positive as far as the legislative actions in New Jersey, but the findings that you have just indicated seem to go counter to that.

Mr. DEMONG. Thank you, Mr. Congressman. I have not done a follow-up study. I am collecting data to do that right as we speak. You are exactly right. The greatest impact is going to be immediately after the law is passed until the market sorts it out and figures out whether additional costs are necessary or additional fees are necessary or interest rates or anything else. It will be interesting to see the results.

However, I should point out that the legislature in New Jersey is presently amending the law, which may very well change the whole study dramatically. I guess I was trying to use the study just to illustrate that a State law could, and did in this case, have dramatic effect immediately, and that is why I would argue for a very thoughtful national standard which would prevent disruptions in the market as investors search for more certain and less risky investments.

Mr. CALHOUN. If I may, briefly, there was a special circumstance in New Jersey immediately following the passage of the act, and that was that the rating agencies had not yet had time to evaluate the act. So while they were undertaking that evaluation, they announced that they would not rate mortgages from New Jersey. They subsequently completed that evaluation and decided that for the overwhelming majority of loans, there was not a problem and that they would rate those loans. As you noted, as to the final category of loans, New Jersey created this intermediate threshold of covered loans. As to that final category, the legislature is debating now whether it should remove that category, as they did in Congressman Scott's State of Georgia. They tried that category. It turned out to be a major problem and they quickly removed it.

Mr. GARRETT. Yes, but that is exactly the point. The rating agency said that for everything outside of what the intention of the Act was going to cover, in essence they are still okay. It is for exactly what the legislature was aiming at that they still had the question as to what should we be doing with that area.

Mr. CALHOUN. Under the Homeowners Equity Protection Act, HOEPA, there is full assignee liability on high-cost loans and the rating agencies for the last 10 years have taken the position generally that they do not rate those loans. So that is not different from what we have had previously, the New Jersey approach.

Mr. GARRETT. Okay. Professor?

Mr. DEMONG. The study that I did was actually after Standard & Poor's had decided how to rate the New Jersey paper. So the 2

months I did were December 2003 and January 2004, as compared to September and October of 2003. So it was after Standard & Poor's had decided that it would rate paper from New Jersey. The markets were reacting to the implementation of the law. A rating agency action is just one more disruption, and that is the type of thing that I would urge Congress to look for and come up with a national standard so you would not have a State-by-state disruption.

Mr. GARRETT. I know Mr. Green wants to answer that, then I have a question for the Deputy Attorney General.

Mr. GREEN. I was just going to supplement that one of the elements in the New Jersey law is that the borrower enjoy a net tangible benefit from the transaction, but it is ill-defined. I think one of the things that the New Jersey legislature is looking at is that area, because again getting back to the need for clear and objective standards, an ill-defined or even undefined net tangible benefit analysis will be impossible to do. It simply increases the risk that the assignee's liability will have a real-world effect on the ability to purchase that mortgage and make it part of the pool, which has the effect on the overall pool.

Mr. RAITER. If I could just add, having been at Standard & Poor's at the time, the reason that upon initial review of the New Jersey Act, there were some incredibly vague language that implied that any use of proceeds from a refinancing that went into home improvement would open up the investor to a liability that was undefined or capped. There was no way to in fact determine at the time that someone refinanced the house and took cash out that they may or may not engage in home improvements. Therefore, we could not rate any refinanced loan in New Jersey until we got clarity on exactly what the intent was.

Mr. GARRETT. I thank you. I did have another question. I will not do the questions as my time is allotted. I just will say that I have met with used car salesmen over literally the last past week and they are looking for some prime lenders to come into the industry. I am just kidding.

[Laughter.]

Mr. BACHUS. I thank the gentleman from New Jersey.

I have just been informed that Mr. Sanders will not be back. I am trying to cope with that loss.

[Laughter.]

I am going to recognize the gentleman from Illinois, Mr. Gutierrez.

Mr. GUTIERREZ. Thank you.

I guess my first question is to Mr. Raiter. The OCC keeps saying that national banks are not predatory lenders. You indicate in your testimony that you can easily rate subprime loans and make allowances, and that you can do this despite, although I just heard you say that you had a little difficulty in New Jersey, that you can easily rate these loans despite different state laws governing them.

If you can in your agencies as you have testified, can rate these loans and therefore assess risk on these loans, do you see a need for the OCC to issue a predatory lending rule at all, with the claim that it was crucial to avoid a crisis in liquidity? In other words, the OCC came here and said, we are going to have a crisis in liquidity

if we do not issue these preemptive laws on predatory lending. But I read your testimony and listened to you, and it sounds like you figured out a way to rate those loans, so if you can rate them, then investors can know the risk. So what is the issue of liquidity if there is one?

Mr. RAITER. When we analyze a loan and include it in a rated security, as I think I indicated in the testimony, in some cases the risks to the investor exceeds the value of the loan. So if you lend somebody a dollar, but you have to put up $1.50 in order to get your dollar back, you are very likely not going to be lending a dollar.

Mr. GUTIERREZ. I guess, Mr. Raiter, but you have been able to figure that out.

Mr. RAITER. Correct.

Mr. GUTIERREZ. My question is not whether there is a lot of risk to the loan. You are answering my question. You have been able to tell the market, hey, listen, this loan for a dollar could cost you $1.25 or $1.50 in the end.

Mr. RAITER. Right.

Mr. GUTIERREZ. I am just trying to see if I understood your testimony correctly, and that is you have been able to assess risk. If you are able to assess risk, could you tell me how that could affect liquidity then because I guess everybody knows what the risk is?

Mr. RAITER. The way it has affected liquidity, if "liquidity" is the term that you all want to use, is those loans are not getting made. Those borrowers are not receiving the loans under those terms that would put them in a category of a high-cost or a covered loan.

I might just add that we are getting reps and warranties from everyone that uses S&P's mortgage ratings desk that provides that they are not making high-cost loans under any jurisdiction in which they are operating. So the loans that are covered by the law are at this point not being financed in the secondary market. If they are making the loans, they are putting them in a portfolio.

As to your point on the OCC, and I am not a government regulatory expert, but I do believe their issue is with leveling the playing field for financial institutions that they regulate from one jurisdiction to another, not necessarily liquidity.

Mr. GUTIERREZ. I am sorry. You were not here, as you state, for the hearing and you are not a government official and not a member of this committee, so you would not be knowledgeable on the point. We are, as they have come to testify before us. So I think the record is pretty clear that they said we have a crisis of liquidity.

As a matter of fact, since you are an agency that wants to bring clarity, the OCC did not only do that, they did it in a rushed manner. They did it in the stealth of night. They did it under cover of congressional recess. We asked them, we said, OCC, do not issue the rule until Congress comes back to session, and 2 weeks before we got here, they issued the rule. So you can imagine how we might be suspect after we have written them letters. As a matter of fact, this committee, Republican and Democrat, passed an amendment on the budget that basically is saying that the OCC does not have jurisdiction to do this.

So I understand and maybe I asked the wrong person, but it is just that when I read your testimony about being able to rate things, I figure, well, people will know what to buy and not to buy. From my perspective, that is a good thing. People know, a pension fund, do not buy these loans. Maybe they should not buy them because they are bad loans, because you at Standard & Poor's have assessed such a risk to those loans that maybe you have assessed that risk to those loans because they should not have been made in the first place.

I do not think we should get into the kind of argument of, well, they did not issue the loans. Well, maybe they should not have issued the loans. Maybe they were bad loans and we should not just have a system that says, we are going to have rules that allow all kinds of loans, and then in the end kind of see where those loans fit. Because as I have heard testimony here this morning that in the predatory lending, it is 10 times as high; the foreclosure rate. That is a lot of people that are going to suffer. I mean, it is not like a small mistake. Ten times higher than conventional mortgages? That is a lot. That is a lot of people that are going to suffer.

So if it was a small calculation in the market, maybe we could take a look at it, but I think that we should really be careful when the rate is 10 times as high. I think you have answered my question. You can rate these loans. So the marketplace has a reliable place they can go to before they buy or sell loans, because you can rate them. That basically was my question.

Mr. BACHUS. Mr. Gutierrez, you are over 1 minute, but if you would like another.

Mr. GUTIERREZ. Thank you so much. In the absence of Mr. Sanders, I am trying to fill in a little bit for him.

[Laughter.]

Mr. BACHUS. Okay. I have learned some things. I did not realize the OCC issued that thing late at night under the cover of darkness.

[Laughter.]

Mr. GUTIERREZ. Maybe you have not read the letters from your side of the aisle asking them. And since the gentlelady from New York is here on your side of the aisle, and she and others wrote them the letter.

Mr. BACHUS. Was it 2 or 3 at night? What time was it? I am just kidding with you. Please go ahead.

Mr. GUTIERREZ. We can laugh and we can be silly about this experience all we want. The fact is that people, we have had testimony here today that people are losing their livelihoods, and that is a very serious issue. When we have an Assistant Attorney General from Massachusetts who says that she is a law enforcement officer of the State of Massachusetts, elected directly by the people of Massachusetts, and we have a philosophy being groomed here in Congress that at the local level they do it best, and that Washington, D.C. does not necessarily have all the answers.

And we have had Mr. Green come and testify about how wonderful all these laboratories are at the different state levels, I just think that it is a serious thing, because if you lose your house and you are getting ripped off, it is a crime. What we are discussing here are not dollars and cents. We are discussing crimes against

people, and I think that is a very serious thing. So I characterized it that way, and I do not know that we should impugn my interpretation in that way, but that is the way that I see it. That is what I will submit for the record.

Mr. BACHUS. I appreciate your wrapping up. I will say that the institutions that the testimony has been about, none of them are federally insured under the regulations of OCC, at least according to OCC.

Mr. GUTIERREZ. Mr. Chairman, if I could ask the Attorney General a question, maybe we can clear this up, because we have had testimony here that when the New York Attorney General, elected by the people of New York, attempted to engage a nationally chartered bank, that nationally chartered bank told the Attorney General, a law enforcement officer in New York, we do not have to deal with you; we are going to talk to the OCC. And Mr. Chairman, you know, the OCC is only open from 9 to 4, Monday through Thursday.

Mr. BACHUS. Mr. Gutierrez, what I am saying is the institution that we have heard testimony about today was not regulated by the OCC. Thank you.

Ms. Capito?

Mrs. CAPITO. I do not have any questions. Thank you.

Mr. GUTIERREZ. Thank you, Mr. Chairman. I can see this committee who it is being run by and for.

Mr. BACHUS. Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman. I have no questions.

Mr. BACHUS. My first question is for Mr. Green. Mr. Green, you have heard testimony from the Assistant Attorney General and from Mr. Calhoun and others that there is a situation where there is a predatory or abusive practice or tactics employed that harms consumers, and the lender or the broker is, as in the case of Massachusetts, was bankrupt, so they are not really subject to legal recourse. You have a situation where you either have a, let's say, innocent assignee or innocent victim. At least in the case of predatory lending, wouldn't it be better to hold the assignee liable than the innocent victim, in that the assignee at least should have been in a position to know?

Mr. GREEN. I think it is a great question because that is precisely why we have come to the conclusion, after looking at all of what is going on in the marketplace now, after looking at what the various States have done, to that a national standard—one that provides clear and objective assignee liability that can be identified.

And picking up on the gentleman from S&P, focusing on the damages side, that if you had a national standard that accomplished that in an objective and clear way, in fact there ought to be assignee liability and that assignee liability ought to be enforceable. But when it is not clear, when it is a patchwork quilt around the country, it makes it very difficult to operate in an efficient, cost-effective, or even just-effective way.

Mr. BACHUS. I guess what you are saying is as long as they are able to price the liability risk?

Mr. GREEN. If liability is going to be accepted, you have to know what is going to impose it, and that clear and objective standard makes that doable.

Mr. BACHUS. And as long as there are clear standards as to what the liability would be?

Mr. GREEN. Yes, we would support and look forward to working with you. I know there are several pieces of legislation in the works just among this committee, Congressman Ney, Congressman Watt, and Congressman Baker today. We would look forward to working with all of you to try and find what that right definition is.

Mr. BACHUS. Okay. The GAO found in a study they released earlier this year that by separating ownership of a loan from its originator, the secondary market for subprime loans may in some instances undermine efforts to combat predatory lending. I am going to quote from the GAO report, "The existence of a market that allows originating lenders to quickly re-sell subprime loans may reduce the incentive these lenders have to ensure that borrowers can repay." How do you respond to the GAO suggestions that the secondary market may, at least in some instances, facilitate predatory lending?

Mr. GREEN. The analogy that comes to mind, if that was a question for me, is a way of reducing car accidents is to prohibit driving. The fact is there is a big market for people who need credit, who need access to capital, and they may not have pristine, clean track records. The subprime markets provide them access to credit.

It should not be surprising to anyone that the foreclosure rate is higher in the subprime market. They are riskier loans. That is why they are made in the way they are made. That is why they do pay a higher interest rate because they are a riskier credit, and riskier credits do have a higher risk of failure, so the fact is that there is a higher foreclosure in that category of loans. But if the foreclosure rate, which I heard earlier is 5 percent, that means 95 percent are people who needed credit are not facing foreclosure. Without that deep liquid secondary market, they may not have the same access to credit that they currently have to be able to reach their own life's dream.

So I would say that while the GAO may be technically correct, it is losing the forest for the trees. The important thing is you want to create access to capital for those who want it and deserve it and need it, and you have to deal with the problem of predatory lending more straight-on.

Mr. BACHUS. What about the North Carolina law? Do you all find that to be a fair law? I would ask you, Mr. Green.

Mr. GREEN. I guess we have found that the North Carolina law, specifically on predatory lending, has less vagueness in the assignee liability and frankly the body of their specific predatory lending stays away, as the previous witness said, from assignee liability specifically. So it has been a law that most of the marketplace has perceived to be a more workable standard than what we found in other states.

Mr. BACHUS. So you found that the North Carolina model at least does not inhibit the mortgage capital?

Mr. GREEN. I never say never.

Mr. BACHUS. It does not appear to be. I mean, we have experience with it now.

Mr. GREEN. Right. But I think it would be a good standard as this committee furthers its look at potential legislation. It would be a good standard to look at.

Mr. BACHUS. Okay.

Mr. CALHOUN. Mr. Chairman, may I clarify two things? First of all, Mr. Green was referring to the 5 percent foreclosure figure. I want to make it clear, that is 5 percent of subprime loans which are currently in foreclosure. That is this year. Next year, there are going to be more loans. It is not that 95 percent of these loans are going to stay out of foreclosure. It is this year, 5 percent are in foreclosure. Given the average span of a foreclosure process, which is in the range of a year, next year we are going to get another 5 percent of them. We are talking about huge numbers of families losing their homes in this market.

The other one point is, on the North Carolina model, I want to be clear. North Carolina was the State that developed the prohibition against flipping, that there has to be a net tangible benefit. That applies to all loans in North Carolina. We also have a couple of safeguards. You have to prove that it was an intentional violation by the lender, and some other safeguards. We went through a lot of time trying to come up with a very specific standard. Both lenders and consumer advocates found that all of those standards were over-or under-inclusive.

Mr. BACHUS. Let me ask you this, my time has run out, I think what Mr. Green is saying is that the industry can live with the North Carolina law.

Mr. GREEN. I am saying it is a good starting place to look because their approach——

Mr. BACHUS. Has it limited liquidity to any great extent? I am not trying to put you on the spot.

Mr. GREEN. You are doing a good job.

[Laughter.]

I would say that the North Carolina law has examples in it that the industry does feel are more precise and objective than what we have experienced in other states.

Mr. BACHUS. Okay.

Mr. GREEN. The right place to be on a national standard is probably not going to be exactly where the North Carolina law is.

Mr. BACHUS. I understand. I am just saying it is workable. I think Mr. Calhoun is saying, at least what I hear, is that it is protecting consumers.

Mr. CALHOUN. That is correct, Mr. Chairman.

Mr. BACHUS. Maybe I am oversimplifying this process, but that is sort of what I am hearing.

Ms. Waters?

Ms. WATERS. Thank you very much.

I think it must be understood that those of us who fight so hard against preemption appreciate the fact that some States work very, very hard to get rid of predatory lending. When we move to so-called definitions at the national level, all of that is going to be weakened. The whole idea, I have discovered, of wanting to preempt state laws not only as it relates to predatory lending, but in some other things, is basically to weaken the laws of States that have strong laws to protect their consumers.

I want to ask Mr. Calhoun because we keep hearing how much folks care about folks with bad credit being able to have access to credit and to get these mortgages. I am very grateful for that, that people care so much about people being able to have access to credit. As I said when I first started to speak, I do not mind subprime lending that is fair, but there are some other details that we have to look at with this subprime lending. I want you to discuss for me two or three other things that make subprime loans bad, that turn them into predatory lending.

For example, you talked about loan flipping. I want to tell you, we see a lot of loan flipping. I want to hear something about late payments. I want to hear about some of the other things that turn subprime lending into bad loans. We are not opposed to somebody getting a percentage point more for a loan because someone has shaky credit.

Now, if the credit is too bad, then I do not care who it is, they should not have a loan because they are not going to be able to pay it back. If you know that they do not have the income by which to make these payments and they are going to get in trouble because they simply cannot afford the loan, then it is sinful, it is shameful to advance that loan because you are simply going to cause people to lose a lot of money.

Also, Mr. Calhoun, I have had so many complaints, people coming to my office. These loans are sold so many times they do not know who they are paying. This is one of the tricks. Folks do not know who the payment should go to because it has changed hands so many times, and that is how they get caught, getting late and getting behind trying to track down who this payment is to go to, because the loans has been sold three or four times.

Help me to understand and this committee to understand some of the other factors that go into predatory lending, so that people do not get the idea that we are just railing against subprime lending.

Mr. CALHOUN. I think one of the most important lessons that has come from the homeowner protection act that this Congress enacted 10 years ago, and the experience in North Carolina, is that unscrupulous lenders will simply change tactics unless you have comprehensive protections.

The North Carolina law is actually pretty modest. It sets a threshold for high-cost loans at 5 percent lender fees. So we are talking a $100,000 loan, $5,000 of lender fees, excluding things like appraiser, attorneys fees, et cetera. We want to make it clear, that is not a benchmark for a good loan. I do not think many of us would be happy with a loan like that or happy if our parents or our family received a loan like that.

It is meant to be a generous threshold so that it does not restrict access to credit. But the important thing is that it includes all of the fees. We leave the flexibility to the lender and the borrower how they want to structure the loan. Do they want to have small up-front fees but a big prepayment penalty? Do they want to have a large origination fee and then not many other fees? If you do not include all the fees, the lenders' experience has been under the federal act simply change the name of the fees or restructure the loan to evade the law's protections.

We see that under your current federal law, HOEPA, in for example prepayment penalties which are perhaps the biggest looming problem in the subprime market. There are virtually no prepayment penalties in the prime market. They have now developed to be on the majority, almost 80 percent of subprime loans, and they are often as much as 5 to 10 percent of the loan amount. So when you go in to pay off $100,000 loan, they take another $5,000 or $10,000 out of the equity.

Under the federal law, the size and presence of prepayment penalties are not considered at all in determining whether it is a high-cost loan. Today, a loan with a 20 percent prepayment penalty is not a high-cost loan under the federal Act. If you leave a fee like that excluded from determining whether it is a high-cost loan, then the bill will just simply require people to change how they structure the loans, change the names of the fees, but will not end up at the end of the day protecting borrowers. That is one of the most important lessons.

The other is that you need a flipping standard applying to all loans. As we heard from the Assistant Attorney General, virtually all of these lenders make money by refinances. They collect a new set of fees and their loan officers are trained and pushed to try and get a refinancing at every chance. Repeated refinancings are what see currently under HOEPA, where a lot of the lenders charge 7.99 points to stay under the 8 point threshold for high-cost loans under your federal law. If you repeatedly refinance at 7.99 points, it does not take very long to take away all of the home equity.

Again, that is totally legal under your current federal law, and we have seen examples where people have been refinanced three or four times in a year at 7.99 points. That is not a high-cost loan. It is not a violation of any of the federal protections at this time.

Ms. WATERS. Are those the major kind of items that you have covered in your North Carolina laws dealing with predatory lending and that you would want to have covered in any federal preemption? If there is going to be one, and I hope not, are those the major concerns?

Mr. CALHOUN. Yes, Congresswoman. To emphasize, the high-cost loan threshold does not bar high-cost loans. There are HOEPA loans made today by some lenders who specialize in that, and there are some high-cost loans being made in North Carolina. But again, under current standards for a high-cost loan, you are talking about a loan with more than five points up front, or interest rates in today's market of more than 13 percent. We feel like, and the experience in North Carolina has been, that credit is readily available for almost all borrowers within those constraints.

Ms. WATERS. What about late payments?

Mr. CALHOUN. Most States have some provision to protect consumers in both mortgage transactions and other transactions, on late payments. There are some lenders who try abusive practices where they will extract one late payment and make all your subsequent payments declared therefore late. Or they use late payments as a wedge to try and force a refinancing and a flip. So that is an important area to have protections.

Ms. WATERS. Mr. Chairman, I am going to yield back the balance of my time, but I would really like if at all possible for Mr. Green

to give me his ideal. You know a lot about this subject. You have worked it quite some time. If you were going to advance a federal law, a change, an improvement to deal with predatory lending in the subprime market, what would you advise us to do? What is acceptable to you? You kind of nodded your head on Mr. Calhoun's North Carolina law, but you did not quite say you support it. What do you support?

Mr. GREEN. At the end of the day, the specific criteria for what is a predatory loan is something that the originators of the loans and this committee and others need to figure out, what are the best identifying criteria. From the secondary market perspective, what criteria are utilized is less important than the precision with which those criteria can be identified.

Many of the criteria that are looked at in the North Carolina law carry with them objective standards. It is when the criteria becomes more vague and esoteric and theoretical and less precise that it becomes much more difficult to value and to identify a loan in a pool of hundreds, maybe thousands of loans as to whether or not it meets that standard. Even if you could identify it, you have no way to control whether or not you have met that standard.

So to hold someone liable and assign them liability for something they cannot identify and cannot control is where the problem in the marketplace arises. If the criteria can be identified and is objective, you can begin to implement something. That is why we suggest a national standard. I do not want to use the "preemption" word. I guess there is no way around it if you are going to use "national standard." I think everyone agrees that this is a national problem. The marketplace that you are focusing on is a national market, and we have had experiences in the laboratory of state legislatures where it has been difficult to establish that enforceable, quantifiable objective standard.

Ms. WATERS. I respect that, but let me just tell you, bankers know how to count and they know junk when they see it. Prior to coming up with ways by which to make money in the subprime market and with predatory lending, they use the same eye to tell people no, you cannot have credit because you do not look like you can pay this back. You look like you are a bad risk.

So they know it. They understand it. And when they are protected and they can roll the dice on it and they can make a lot of money with high interest rates and other kinds of fees et cetera, and they have no liability, they will take a chance. So I am not at all impressed with the fact that they just do not know bad paper when they see it. They know it quickly and surely.

Chairman NEY. [Presiding.] The time has expired. I would note, Mr. Green, I believe, does have to leave, so if you have a question.

Mr. Fossella of New York.

Mr. FOSSELLA. Yes, to follow-up on that. Thank you, Mr. Chairman.

Mr. Green, you talk about subjective triggers. "Unintended consequences" is perhaps a phrase that comes to mind in our efforts to curtail abusive practices, which I think we all agree with, should be curtailed and ultimately eliminated.

But can you be more specific as to why a national standard is necessary by quantifying perhaps how some people are ultimately

shut out of the market, if that is a conclusion from all these nebulous, esoteric standards, as you in your testimony call them, subjective triggers to assign liability? How are people actually shut out by limiting access to capital and the folks who are actually purchasing these loans?

Mr. GREEN. At the end of the day, the secondary market succeeds because people pay their loans back. It is not in anyone's interest to have loans in a portfolio that are not going to perform. Now, there is a risk of nonperformance in any loan, even the highest-rated credit has a risk of nonperformance. But in higher and riskier borrowers, that risk is higher.

In order to make sure that they are in compliance with the law of a particular state, they will take certain actions. That will have an effect on their ability to accept loans that extend credit to that higher-risk category. If they do not accept those loans, those loans are never made.

Now, where the line is between loans that should be made and should not be made is a difficult public policy question, because you do not want to draw the line so that nobody gets loans because there are lots of people that deserve them. But the viability of the secondary market ultimately defines the extension of credit. If we can come up with tangible, identifiable objective standards that can be enforced on a national level, you can make the marketplace work much better than the current situation allows us to have happen.

Mr. FOSSELLA. So is it safe to say that ultimately if this were to be left unaddressed that there are going to be people who fit subprime criteria that would ultimately be shut out of the market?

Mr. GREEN. I think as Mr. Raiter indicated that the risks that are in the marketplace when you can or cannot get a rating have an effect on whether or not credit is extended in the first place. So the answer is yes. I dare say I think that the risk of that is greater in a rising interest rate environment when credit itself, by virtue of its cost, is less accessible.

Mr. FOSSELLA. So to Mr. Raiter, are there situations, and you may have said it in your testimony, forgive me because I was not here, are there situations in which at the State level laws were passed and ultimately you in your testimony indicate that you support these measures, but at the same time recognize again these unintended consequences that result? Did you notice a pushback in some States that are considering legislation that would be inconsistent or at odds with the federal standards right now?

Mr. RAITER. At odds with the federal standard?

Mr. FOSSELLA. Are there laws that have taken root in the States where as a result of this liability imposed on the purchasers, States have had to modify and change, and what, if any, has been the impact in other states that have been considering similar legislation?

Mr. RAITER. I can comment on the changes that were made in Georgia.

Mr. FOSSELLA. Yes, specifically yes.

Mr. RAITER. And the changes that were contemplated in New Jersey, and after the original law was promulgated and enacted, there was an Attorney General opinion on how it would be interpreted that had an impact on how loans would be treated when

they came in for ratings out of the New Jersey markets. What other jurisdictions may be doing when they see the impact of changes in those two jurisdictions, we have not tracked. We have looked at the individual laws as they become enacted.

I think the other answer to the first part of the question is the high-cost loan categories in all the jurisdictions that have gone into effect are not showing up. If they are being made, they are not being financed in the secondary market with transactions that are rated by Standard & Poor's, which may be exactly the intent of these various laws and statutes, that those loans are undesirable. Whether they are predatory or not would depend again on whether we could identify exactly what the requirements for falling into a violation were under the statutes.

If it was clear and defined and we could size the risk, then we would put a number on it. If it was not clear and defined and we could not tell whether a loan was or was not really predatory, then they would have to be excluded. So if it is the intent to basically prevent these types of loans from being financed in the secondary, then it would behoove the legislators to be as specific as they can in identifying what is a violation and what the penalty is, and the loans will not make it to the secondary market because it will not be economically feasible, as they are not making it now.

We do not have any issuers that are checking the blocks and telling us that they are including high-cost loans. They are giving us a warrant that if in fact they inadvertently acquired a high-cost loan, they will immediately buy it back.

Mr. FOSSELLA. This will be my last question. Are you prepared to say whether it is a better public policy to ensure that as many loans are allowed to flow into the secondary market as possible, or are you neutral on that?

Mr. RAITER. We are neutral on public policy, but you all should be quite aware that where you draw the line, it is likely that the loans that fall above that line probably will not be made.

Mr. FOSSELLA. All right. Thank you, Mr. Chairman.

Mr. DEMONG. Congressman, can I add to that?

Mr. FOSSELLA. If you like.

Mr. DEMONG. The study that I did in New Jersey showed an absolute drop in certain subprime loans, including cash-out refinancing, probably at least a 60 percent drop in the first 2 months after the Act. But to go directly to your question, can you quantify the folks that do not get the loan; you are not going to hear from them. It is tough to measure that folks that do not get a loan. So we can see a change in lending based on a law, and I would argue that we are better off with a national standard because it is a nationally funding market.

But to address the second part of your question, yes it does matter if a law affects the secondary market, affects securitization, in that there are going to be less funds available for potential borrowers in that state or in that region. So there will be a direct impact if the secondary market securitization market is cut off.

Mr. CALHOUN. If I may add one thing, I think there is a very important distinction here. This is a dynamic market. What the experience has been under the federal law and under the State laws, it is not that people stop making these loans. Rather, the loans are

restructured so they do not have the predatory impact on the borrowers.

The main predatory feature of loans has been fees that strip equity. So simply what a lender can do is structure the loan with a higher interest rate, because for example the North Carolina law follows the federal interest rate trigger, but takes less money out of the fees. It is these high up-front fees and high prepayment penalties that have encouraged all of the equity stripping, the repeated refinancing.

It is important. In North Carolina, we advocated strongly, do not change the interest rate threshold from the federal standard. Allow plenty of room for these loans to be made. Remember, for most subprime borrowers, hopefully these are bridge loans so that they can improve their credit and move to a better or a prime or closer to prime loan. If the loan is loaded up with large up-front fees and prepayment penalties, the borrower is blocked from doing that, from doing what I would hope we would want to encourage these borrowers to do. If instead the loan has more in the interest rate, the lender can still make a fair profit, which they have to do, but the borrower is not trapped long term in a predatory loan.

Mr. FOSSELLA. Thank you.

Chairman NEY. Mr. Miller of North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Mr. Raiter, Mr. Green I think praised North Carolina's law, but I think by faint damnation, and said it was not as imprecise; the prohibitions were not as vague; not as subjective as some other states. But in rating subprime loans coming out of various states, you did not rate North Carolina's loans. I do not want to talk you into doing that, but could you tell me what was different about North Carolina? Did you do that based on the provisions of North Carolina's law? Or did you do that based upon the experience under North Carolina's law? If it was based upon the provisions, what were those provisions? And if it was based on the experience, what has been the experience?

Mr. RAITER. Specifically, it was based on both. The provisions of the law incorporated that violations, the borrower had to prove that it was knowingly and intentionally committed, and that they had a pattern or practice of violating the law. At the same time, the North Carolina law had a provision that if a plaintiff did not settle a reasonable settlement to alleviate the issue, then I believe the plaintiff could be charged with the legal expenses.

So the actual experience in North Carolina is there were no actions brought under this law that were going to assignee liability payment beyond where the loan was initially made. So it was structured in such a way that the problems that did arise were being solved and resolved locally, and that the risk to the investors in the pool that held those mortgages had been successfully mitigated. But there were still the high-cost loans. There are still loans that we have not seen. People are giving us the rep saying they are not doing loans that exceed the thresholds that were incorporated in the North Carolina law.

Mr. MILLER OF NORTH CAROLINA. Okay. Mr. Green, I think you have spoken of the burden of knowing what loans in a package may be illegal under some State's laws. Does any State require a

duty of inquiry absent actual knowledge? Does any State require a duty of inquiry that goes beyond the loan documents?

Mr. GREEN. I am not sure. I do not know the answer to that question as it relates to states, but I do know there are clear due diligence requirements that have to be done before packaging the loans into a security. That due diligence is really what we are talking about here, and whether or not the due diligence can be accomplished in a way that is honestly achievable.

When there is vagueness fulfilling that due diligence by looking at the bond documents themselves, will not get you there, because you have to look at what the intent of the loan was, what the desire was, what the conversation that took place between the loan originator and the person, as opposed to something that will come through on the face of the bond documents.

With a clear or objective standard, you will have something that will come through on the face of the loan documents that will allow for a much easier identification. As you said, I think the goal here is to keep out of the pools the loans you do not want in the pools, but to make sure that that which you want to move forward and finance, can.

Mr. MILLER OF NORTH CAROLINA. Which State or which locality requires a purchaser of a loan to know about oral dealings between a lender and a borrower? Isn't it all based upon the written documents? The duty of inquiry under HOEPA is to be what can be determined based on the documentation required by this chapter. Isn't it all based on the documents?

Mr. GREEN. You look at the imposition of a vague, net tangible benefit rule to determine whether or not there is a net benefit. You have to get to what motivates someone to refinance a mortgage. You have to get beyond the bond documents because what we are talking about here are things that cannot be reduced to words on paper. They get to subjective judgments. It is those subjective judgments that are precisely the things that we have a concern in certain States that are creating the problem. A set of objective standards would be the solution to that, because you would have something to look for, something to identify and something to act upon.

I will tell you further that if you had such standards, and in those states that do have such standards, if a packager of mortgages in the secondary market has done their due diligence and still has those loans in their pool, they should be held responsible. We would support that. But the fact is, when it is a vague standard, how possibly can you ultimately hold them responsible for that which they cannot easily identify?

Mr. MILLER OF NORTH CAROLINA. May I continue just a bit?

Chairman NEY. If we can wrap it up quickly.

Mr. MILLER OF NORTH CAROLINA. I did notice that the light was a fairly bright shade of yellow.

Chairman NEY. A whiter shade of pale. Go ahead.

Mr. MILLER OF NORTH CAROLINA. One last question, and I suppose also for Mr. Green, although perhaps Professor DeMong as well. Mr. Israel quoted Potter Stewart's opinion earlier, saying he did not know how to define pornography, but he knew it when he saw it. John Hawke testified before this committee earlier. OCC has preempted state predatory lending laws with respect to OCC-

chartered institutions and their affiliates. In a speech to the Federal Society last year, he said his definition of predatory lending was making a loan that the consumer could not repay. It did not go beyond that definition. It was making a loan the consumer could not repay.

I use an example that Self-Help has given here, and I cannot recall all its details, but an elderly school employee, probably not a teacher, probably a cafeteria worker in Durham, borrowed $99,000 for home repairs that were desperately needed to maintain the value of her home. To make that loan, she was charged $23,000, I think it was, in up front points and fees. She left the loan knowing how much money she was getting at closing and knowing what her monthly payments would be. She could make the monthly payments, but sometime later when she went to Self-Help to refinance the loan, she learned that she had lost $23,000 of the equity in her home, her life savings, at the moment she signed those loan documents. Is that predatory lending?

Mr. GREEN. I am not a Justice on the Supreme Court. There are lots of scary anecdotal examples of what certainly sounds like predatory practices. Frankly, I would hope that the originating community would honestly try to define with policymakers what a predatory loan is. In the secondary market, whatever you decide it is, so long as those standards are objective, we will be able to deal with that. But as those who are involved in the secondary market, it is hard for us to determine specifically what predatory lending is.

That certainly sounds like a predatory practice. Up-front fees and all the criteria that were mentioned, late fees, loan flipping, balloon payments, the repayment ability, and you did not mention negative amortization, all those things appear predatory. They can be predatory. They do not necessarily in and of themselves have to be predatory. That is the difficulty, but I think we need to come up with that so that we can have that objective criteria.

Mr. MILLER OF NORTH CAROLINA. So in the eyes of Mr. Hawke, he saw that loan as not predatory. Do you disagree with Mr. Hawke?

Mr. GREEN. I have not read his entire statement, so it is hard for me to know exactly what he said. Having said that, predatory practices certainly sound like big up-front fees. I think you need to look more deeply to see whether or not that made that loan a predatory loan. There are lots of factors that take place. So I would not agree or disagree.

Chairman NEY. The time has expired.

Mr. MILLER OF NORTH CAROLINA. Mr. Chairman, Professor DeMong had his finger right on the button. He was just itching.

Chairman NEY. I am going to take this time off Mr. Scott. If you would like to proceed, you can ask him. Mr. Scott, do you want to yield some time?

Mr. SCOTT. Right now, I have my own fish to fry on this issue.

Chairman NEY. There you go.

[Laughter.]

Mr. SCOTT. If I have a little time, I certainly will. Let me get my points out.

This has been a real fascinating hearing and very informative. I am concerned about preemption. I am also concerned about making

sure that we move forthrightly with the strongest efforts to stop predatory lending. Nowhere is it more impactful than within minorities, the elderly, African Americans, and we are all very much concerned about that.

I also happen to believe that assignee liability is critical in my estimation to preventing predatory lending practices. I think that Mr. Green has given us a shot into the darkness as a way to kind of begin to move out of this. But I believe that we are going to have to come to some illumination between Mr. Raiter and Mr. Calhoun. Here is my point.

In my State of Georgia, we put forward predatory lending, and Mr. Raiter came in and kind of negated that with the Standard & Poor's rejection of rating these mortgages. Fannie Mae, Freddie Mac would not purchase mortgages because we had assignee liability. Yet in North Carolina, as Mr. Calhoun said, he had assignee liability. These things did not happen. Standard & Poor's did not come in and say they would not rate these. Fannie Mae, Freddie Mac, they did not say anything at all.

I think it would be interesting for you to just point out very clearly, what is it within your application of assignee liability did you do, and in your opinion, did Georgia go too far in its application of assignee liability, and if so, where did it go? First you, Mr. Calhoun.

Mr. CALHOUN. Thank you. I think everyone here should know what a critical role you played in making sure that the Georgia law worked for both consumers and ultimately for the market. For the record, the subprime market in Georgia is thriving even with the remaining very strong protections in that law which you helped very much shepherd through.

Shortly after passage of the Georgia law, since we have been involved in assisting in that process, we were contacted by secondary market players. They said, we have some concerns about the assignee liability provisions. I think the real message out of that and today is that these issues are largely solvable. We reached agreement with those secondary market parties.

And then initially, several of the rating agencies said, we do not have a problem with the Georgia law; we are going to allow what in the industry are known as reps and warranties. I think it is important for everybody to understand that these purchasers are not out there holding the bag. Whenever they purchase the loans, they make the seller pledge that if this loan is illegal and has liability, you have to indemnify me, the purchaser.

So this assignee liability really comes up with the problem of what happens when the originator disappears or becomes insolvent. But you should know that usually the purchaser is protected by these so-called reps and warranties that they insist that the sellers of loans provide to them.

So initially, other rating agencies said, we are going to rely on reps and warranties; we are fine with Georgia. S&P had concerns in particular about the possibilities of unlimited punitive damages, I think that was their major concern. To their credit, we worked with S&P as well as Senator Cheek, who you know well from Georgia, and S&P quickly reached agreement on what were acceptable assignee liability issues, and those were resolved.

The delay in passing those provisions was that it got caught up in a bill where there were debates about what were substantive triggers, what were the other provisions of the law to look like. That is what slowed it down. The assignee provisions that were acceptable to S&P are not the ones that finally came in there. Those got changed some. But the assignee liability issue was resolved relatively easily. The important thing is that there be comprehensive standards. I would urge you that it is not an either/or on the preemption. If you have strong federal standards, you will find the States backing off.

There have been questions about municipal ordinances. I think one of the lessons from North Carolina is, we had no proposed municipal ordinances ever in North Carolina. The reason is there was not a need for it. There was no void for municipalities to mess with. They have plenty of other things to do. We had a good state standard. I think you can have the same effect at the federal level if you pass a good federal standard. The states will have no need to move in here.

The Truth-in-Lending Act is that way. It does not have preemption, but you passed a comprehensive, strong standard, and the States, I think there is one state out of the 50 that has some mild supplemental provisions, but there is no move and there has not been in 30-something years for states to move into that area, even though they have the authority to do that. Truth-in-Lending is a floor, not a ceiling, but it provides comprehensive protections and there is no need for the States to move in.

Mr. SCOTT. Now, Mr. Raiter, that was your major concern, unlimited liability. That was the only difference between Georgia's assignee liability and North Carolina's was the unlimited liability. That is the reason why you would not rate the mortgages.

Mr. RAITER. That was the most significant issue, the punitive multiple damages that were unlimited. There is some mitigating language, as I mentioned earlier, in the North Carolina law that makes it much more friendly to resolving the issues so that the ultimate assignee does not get involved in the transaction, but it again goes back and relies on the reps and warranties that Mr. Calhoun was just describing.

Chairman NEY. The time has expired.

Mr. SCOTT. Just one final little point, thank you, Mr. Chairman, just to get a summation. Is it the consensus of everybody on this committee that our Financial Services Committee should come up with a uniform federal standard for assignee liability?

Mr. GREEN. Yes.

Mr. SCOTT. Everybody?

Mr. DEMONG. I would support that. Just as it was pointed out that it is important to define predatory lending for the secondary market, it is also important for the originators. Having a clear law serves both purposes well, and will enable the credit to flow to those that should have it and deserve to have it.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. CALHOUN. For the record, States have traditionally through the Uniform Commercial Code, which is close to uniform in the various states, made the decision about assignee liability, including in mortgages. There currently is liability for assignee's in certain

circumstances under the law of almost all of the States. We would suggest if you have the uniform standard, that that is going to take care of this issue.

I think the States have learned their lesson. No one will be more responsive to an interruption of the credit market than State and local officials because they are the first people who get called, as you know well, if there is any disruption in the market. Local officials have learned from these state laboratories. They are not going to disrupt their markets.

Chairman NEY. I have let things slip a little bit. We are going to stay on time so everybody gets their questions in.

The gentlelady from New York, Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Raiter, Standard & Poor's recently announced that it would require credit enhancement for loans governed by anti-predatory laws in 14 states, including high-cost loans in New York State. Can you comment on how the New York anti-predatory lending law is affecting the ratings, and consequently the purchase of loans in the State?

Mr. RAITER. In a nutshell, we are not seeing high-cost loans from New York State.

Ms. VELAZQUEZ. You are not seeing them.

Mr. RAITER. No, we are not.

Ms. VELAZQUEZ. What about the New York City ordinance?

Mr. RAITER. I believe that was overturned. I do not believe that is in effect any longer.

Ms. VELAZQUEZ. So is it true that your new credit enhancement criteria will affect a very small portion of the subprime loans originated in New York and across the nation?

Mr. RAITER. We have no way of going back in time and determining how many loans that would have failed the test before the law went into effect. All we know is that the lenders that are operating in New York, as has been pointed out here, they are either changing the fees or they are changing the rates, or they are not granting the loans, but they are giving us the rep that they are not engaged in high-cost lending in New York State.

Ms. VELAZQUEZ. Thank you.

Skyrocketing defaults and foreclosures are devastating many low-income communities around the nation. In some areas like in my district, many of the foreclosures are on subprime loans, and we have been hearing about that all morning. Wouldn't you agree that requiring that recipients of subprime loans are simply made aware of the availability of counseling could go a long way in decreasing the number of defaults and foreclosures? Please note I am not talking here about mandated counseling, but the availability of counseling. Mr. Calhoun, would you like to start?

Mr. CALHOUN. I favor the approach that is in the North Carolina law that has worked well. That is that the North Carolina law requires counseling for high-cost loans only. That is the whole philosophy of the law. The high-cost loan is a loan that is not always a bad thing, but it is very susceptible to abuse. So you should have special protections when somebody wants to charge more than five points or more than 13 percent interest on a loan secured by a person's home. The truth is in most of the foreclosures, these are gold-

standard loans. They are backed by people's homes, and we know from 20 years of lending experience that most people will do about anything to keep their home.

Ms. VELAZQUEZ. Would you support legislation that required lenders to make subprime borrowers aware of the availability of counseling?

Mr. CALHOUN. Yes, but we do think it also needs to require counseling on high-cost loans. That is done presently under the law in a number of States for reverse mortgages, because again they are very susceptible to abuse. In those rare circumstances, the counseling should be required.

Ms. VELAZQUEZ. Dr. DeMong, would you like to comment?

Mr. DEMONG. As a professor, I am always in favor of education. I have done some work with 401(k) plans, and having people know what they are investing in is always better than not. So to the extent that you could have education that will help people better understand the provisions of the loan, what it obligates them to, is always better than not.

Ms. VELAZQUEZ. Would any of the other witnesses like to comment?

Ms. KOGUT. Yes, I would just add that in the First Alliance Mortgage Company case, we would have loved to have had our victims undergo counseling. Sometimes we were the first people to tell consumers that they paid points in the amount that they had paid. It was painful and horrible to let them know that the equity in their house had been lowered as dramatically as it had been. We were frankly shocked that we were the people breaking that news to them. If they had only taken their loan papers and had them reviewed by a third party, a lot of the abuses we think could have been avoided. So we it would be very useful.

In Massachusetts right now we have a bill that is working its way through our legislature that would incorporate some of North Carolina's provisions into it. We would have mandated a credit counseling provision for high-cost loans, which we think would be a good idea.

Ms. VELAZQUEZ. Thank you. Any other comments?

Mr. GREEN. I would only say the Bond Market Association is a strong advocate of investor education. In fact, on our own Web site, investinginbonds.com, we get over three million hits a month about what people should know about bonds. The questions you are asking are really in the loan origination side. What kind of education is undergoing between the borrower and the lender? So I would hope that that level of education would increase.

On the question of whether or not it should be a criteria, not to sound overly bureaucratic, but I would come back to how objective and clear that criteria can be in determining whether or not that criteria was met.

Chairman NEY. The time has expired.

Ms. VELAZAQUEZ. Thank you, Mr. Chairman.

The gentlelady from New York, Ms. Maloney.

Mrs. MALONEY. I would like to thank you all for your very thoughtful testimony on this important issue. I would like to ask Mr. Green, we have a number of laws across the country that are different in States. Given the fact that the reports that have come

back show that the subprime lending is growing, it is strong, it is out there helping people, why do we need a national standard? We just passed, as you know, the Fair Credit Reporting Act, and there was a very clear need for access for credit that was really critical. It was a staunch need.

I do not see a staunch need for a strong federal standard. Why is there such a need for a federal standard here? It seems like the market is strong and there are many loans being given, and it does not seem like it is a big, big problem to the bond market or to the industry in a sense. Could you elaborate?

Mr. GREEN. I can try. The market has certainly grown over the last several years, as has the mortgage market, as has the municipal markets. That is in large part because of low interest rates, rising home values, the ability for people to tap equity. So a rising size of a marketplace does not necessarily translate itself into all those who need and want access to capital and deserve access to capital can get that capital.

Particularly now that we are on the cusp of a rising interest rate environment, when the sheer cost of capital is likely to go up, those access questions become even more relevant. I think what we are talking about here a national standard would ensure that you get it as close to right as possible, so that where you draw the line of the loans that you want to stop versus the loans that you want to encourage, which is really what we are talking about here, is as close to right as possible.

What we have experienced in both the numerous state laws and some local laws is that the effects of that being more right or wrong is not manifesting itself in nationwide volume of subprime lending, but it is manifesting itself in whether or not you are getting any high-cost loans in these pools. If you are not getting any high-cost loans, you might say, well, that is good. Except, what is a high-cost loan? If the standard is wrong by how you are identifying what these loans are, you in fact may be cutting off capital to those to whom you do not want to cut off capital. That is why we believe a national standard will set a more consistent national policy, particularly since the secondary market is a national market. That is where we see the consistency in the argument.

Mr. DEMONG. Congresswoman, can I add to that and support Mr. Green's point?

Mrs. MALONEY. Yes.

Mr. DEMONG. I also want to point out that, as Mr. Green stated, the market has grown, but has it grown to the point that it is satisfying all those who need and deserve credit? That is the question. The other reason for a national standard, besides making sure that the credit is available to those who need and deserve it, is that you end up with a more efficient market, and when you have more efficiency you can have lower costs, therefore lower interest rates for the borrowers that do qualify for loans.

Mrs. MALONEY. But if state standards are unworkable, then a State legislature would act to change it. We have seen that happen. How would a national standard increase access to capital? Would a national standard increase the number of people who could get subprime loans? I do not see the correlation there. Explain it more clearly. I am for access to capital. I believe in homeownership. I

want more Americans to own their own homes and apartments and so forth, but how does a national standard increase that? Maybe Mr. Calhoun would like to comment, or maybe others.

Mr. DEMONG. Thank you, Congresswoman.

Mrs. MALONEY. How does it increase it, a national standard?

Mr. DEMONG. It increases it in that investors have a choice of investing in all kinds of different investments in the United States, stocks, bonds, real estate, you name it. So if you have an efficient market for mortgages, then more of those funds will flow from one asset to mortgage lending. The more efficient the market is, the clearer the risks are, the more willingness that investors will have of taking money that they could have invested in the stock market or the bond market or the international stock and bond market, and put it into mortgage markets.

Mr. GREEN. Congresswoman, that gets to the contribution of the whole mortgage-backed securities market and the securitization market generally. By pooling mortgages and by selling the mortgages from the originator, you create more capital, because they get money for that mortgage and that loan and they turn around and loan it out again. The more supply of capital, ultimately the lower the cost, but the only way you can do that is you have to have someplace to sell that mortgage.

Chairman NEY. The time has expired.

Mr. Davis of Alabama.

Mrs. MALONEY. Would anyone else like to comment, if we could, just for 2 seconds?

Mr. CALHOUN. If I may, very quickly. I think the evidence shows that the liquidity is very high in the market and that states are very sensitive to cutting off any liquidity. So I agree with your premise that a federal standard would not change the liquidity. The states will make sure there is liquidity. We support strong federal standards that are a floor, not a ceiling, to increase protection for consumers under the Homeownership and Equity Protection Act because right now lenders have learned how to largely evade that act and commit predatory lending that does not get caught or protected by that act.

Chairman NEY. Mr. Davis of Alabama.

Mr. DAVIS. Thank you, Mr. Chairman. I will try to be brief so Mr. Ackerman gets an ample amount of time.

Let me try to focus with the panel on something that we have not talked about at all today. There is a lot of agreement, and the statistics are pretty undisputable, that there are racial disparities in the incidence of subprime lending between blacks and whites and Hispanics. Some of that is presumably attributable to a class difference, the fact that obviously you may have higher rates of poverty; you may have those kinds of issues around the minority community. But I want to focus for a moment on the disparity that exists with respect to high-income blacks and Hispanics and low-income whites.

As I understand it, the incidence of subprime lending right now is twice as high in the affluent African American community or the level is double in the affluent African American community than what it is in the low-income white community. There is no good statistical evidence I have seen that suggests that affluent blacks

have worse credit than poor whites, or that affluent Hispanics have worse credit than poor whites. So again, there is no market basis for that distinction.

Now, in the field of Title VII law, as Ms. Kogut of Massachusetts is aware, in the field of Title VII law there is a presumption that if you have a lot of disparate impact lurking behind the door, it is some evidence of disparate treatment. So can some of you speak for a moment about what it is that lenders are doing that is targeting or disproportionately affecting high-income blacks or Hispanics?

Mr. CALHOUN. Let me respond. First, there have been, and we cite in our written testimony, a study, specifically one by a Harvard professor, looking at broker fees paid by borrowers after you settle-out credit score, et cetera. It showed that African American borrowers tended to pay $500 more in broker fees than similarly situated white borrowers; the same for Hispanic borrowers, actually I think it had $600 more per fee. The same types of results have come up in recent studies and litigation concerning car financing, where it has been shown that, sorting out for credit characteristics, that minority car purchasers are paying more for the financing.

A lot of it is there has been a change in this market. You used to go in for a home loan and the expectation would be that you would get the best loan that you could qualify for. That is no longer the case in this market because the originator, and this is one of the features that has been alluded to about the secondary market, is compensated more if they up-sell you to a higher interest rate. If you qualify today for a 6 percent loan and the loan originator, and this applies unfortunately to most banks as well as——

Mr. DAVIS. Let me jump in for 1 second, Mr. Calhoun, because I agree with everything you are saying, but I want to try to drive to a conclusion a little bit. We agree that there is a disparity and that it is one that does not have an economic basis or a credit basis. What I am trying to get at is what we can do about it.

Maybe I should direct this question to Ms. Kogut, since she is the attorney on the panel. If we have a problem with primary lenders going out there and steering these products or steering excessive lending rates to black or Hispanic Americans, first of all, doesn't it seem that we already have something called section 1981 that may provide a remedy for that? Is it possible that we need to be making more aggressive use of our existing civil rights laws, particularly section 1981, to address this problem?

Ms. KOGUT. You raise very good questions. In fact, even in our own office when we have looked at these cases, our Civil Rights Division which is in charge of enforcing our fair lending laws, and we look at federal fair lending laws also, which do exist to protect in communities in this area, we have tried to figure out what is the best approach in terms of bringing cases and getting remedies.

The one thing that I will say, which is just a fact, these loans, you said this in your opening statement, there is no competition going on. The consumers who end up with these high-cost loans are not comparing prices with other loans. For whatever reason, there is something, there is a problem with a fair market in terms of how these loans are given to consumers.

In Massachusetts, our Mayor in the City of Boston has used lots of educational opportunities to try to make members of our commu-

nities aware that they do not need to be taking loans like this and that they should be seeking legal advice when they go to get mortgage loans.

Mr. DAVIS. Let me stop you for one second because my time is running out. Mr. Green, let me specifically point this toward you since you are to some extent representing the industry here today. What does your industry need to do to deal with what in some instances seems to be clear-cut intentional discrimination? I am not just talking about disparate impact. Doesn't it seem that the industry has a significant responsibility, number one, to figure out what your agents and what your lenders are doing to obviously target a lot of these subprime rates toward high-income blacks or Hispanics? Isn't that just a clear-cut instance of plain old discrimination and prejudice a lot of the time?

Mr. GREEN. Congressman Davis, I will answer your question, but I will just clarify that I am here representing the secondary market of these mortgage securities, not the originators.

Mr. DAVIS. I understand that.

Mr. GREEN. I think you raise an excellent point. One of the things the Bond Market Association has done is we created and are very supportive of the Bond Market Foundation, which operates a family of Web sites geared toward basic financial literacy targeted to women, young people, and the Hispanic community. We are working with State Treasurers around the country to reach into states. We are also working now with the NAACP to set up a program that will reach into other communities to educate people about basic finances and where to get money, where to borrow money, and what are the proper practices that ought to be followed.

We represent the secondary market side of it. So I cannot agree with you more. We are trying to do what we can, and our foundation Web site and the work that we are doing is really a way of increasing the education base of various communities.

Mr. DEMONG. Congressman, I spent some time last year studying this issue and studying some of the studies that have been done. They are not as clear-cut as many would expect to find. I think it is ripe for another study that really goes into some of the issues that you have raised. I would support trying to find out if there is discrimination and if so, what is causing it so that it can be resolved. But the studies that have been done so far have been somewhat contradictory on the issue of income, on the issue of net worth, and the issue of race.

Chairman NEY. I thank the gentleman.

Mr. Ackerman, the gentleman from New York.

Mr. ACKERMAN. Thank you very much, Mr. Chairman. I will be brief, as I notice that we are about to be outnumbered by the witnesses.

[Laughter.]

I was listening intently, and Mr. Green made the important point that if 5 percent of the mortgages that were written, it meant that 95 percent of the people were enabled to become homeowners because of the subprime market, which is something that is very good.

Mr. Calhoun then pointed out, without contradiction, that that is 5 percent a year. So I went back to thinking, 5 percent of what? I did, being a broken down old math teacher, use the old math and said if we start with a model of 100 loans made, 5 percent would mean 95 people were in houses that were supported by lenders in the subprime market, and five homes or five families were foreclosed upon. That would leave 95 people.

If you took 5 percent of the 95 the following year, that would be 4.75, leaving 90.25 from the first group of numbers. And if you took 5 percent of that the next year, 4.56 percent would be foreclosed upon, and the next year, 4.28 percent and the next 4.07 percent. In the sixth year, it would be 3.38 percent. So after the end of 6 years, if you add those foreclosures, you have 26.53 families or homes, more than one in four at the end of 6 years from the original group foreclosed upon.

Is there something wrong with my math? Or was there something wrong with the 5 percent, depending on whose 5 percent it was?

Mr. GREEN. Congressman Ackerman, I think your example would be correct if only those 100 loans were made and that in each succeeding year more loans were not made.

Mr. ACKERMAN. That is correct. I would assume out of the next 100, the same percentage would apply, more or less, unless the statistics changed. Of the next 100, at the end of 6 years——

Mr. DEMONG. Congressman, I do not have those statistics so I cannot speak to them directly. However, I will point out that I know the life of the subprime loans tends to be relatively short, I do not know whether it is 3 years or 4 years, but if the life of the loan goes out only 3 or 4 years, the average loan is paid back within that time period and thus the percent foreclosed is down.

Mr. ACKERMAN. Do you know what percentage of the loans are that short? Are there any 15-year loans?

Mr. DEMONG. Again, I do not have that statistic, and I would be glad to try to get that for you, but if the average subprime loan is refinanced in 3 or 4 years, then that would, even at the numbers you are talking about, would not equate to the large number that you had calculated by going out 6 years.

Mr. ACKERMAN. If I go out 3 years, 14.31 percent.

Mr. DEMONG. Again, I do not have the statistics, but I would like to find it for you.

Mr. ACKERMAN. If they were all 3-or 4-year loans, at the end of 3 years, that 5 percent a year would be 15 percent. The 5 percent diminishes because you are starting with a smaller base than 100.

Mr. DEMONG. I do not have that number. I would like to get it for you.

Mr. ACKERMAN. So even based on 3 years, 14 percent at the end of 3 years of people losing their homes is really a staggering number if that number is correct.

Mr. DEMONG. And that is an important point, if that number is. Right.

Mr. ACKERMAN. It is a big number, whatever it is. So it is not really the 5 percent. It is 5 percent a year.

Mr. CALHOUN. To clarify the numbers, first I want to say your analysis is essentially appropriate in that even those loans that are

again pre-paid, they are refinancing. They are jumping back in the pool and are at risk again to this 5 percent foreclosure. But the numbers, to clarify for the record, come from the Mortgage Bankers Association's regular tracking of foreclosure. The current statistics were that 5 percent are currently in foreclosure and they track it by quarter. For this quarter, the first quarter, an additional 1.8-plus percent again went into foreclosure during the first quarter. At the end of the quarter, you had 5 percent in foreclosure process.

Whatever the precise number is, I think it shows, and we cite several other foreclosure studies in our testimony, there is an explosion in foreclosures going on across this country fueled mainly by subprime loans.

Mr. ACKERMAN. At the end of the term, what percentage of the people who have loans in the subprime market refinance within the same market? Is that a big number? You are shaking your head.

Mr. CALHOUN. Yes. I think the data show that most of the loans are refinanced back into the subprime market.

Mr. ACKERMAN. Are most of them in the subprime until their house is paid off? Do we know how many actually get out of the subprime market?

Mr. DEMONG. I think that is an excellent question. One of the things that I want to do at some point is study that exact issue. I understand from some of the lenders that folks do move from the subprime to prime, but I do not have a good statistic for you.

Mr. ACKERMAN. Okay. If you would, professor, I think that would be very helpful for us to understand the industry and what is going on, which leads me to my second question, similar to the question or following up on the question that Mr. Davis had raised. People in the subprime market are people with poor credit, people in the minority communities and less-educated communities tend to have poorer credit. They also have less of an education, of which at least several people spoke previously.

I know that I have a fairly good interest rate. I have a fairly good credit rating. It is because of that, I presume, that I get solicitations because people want my business and they keep offering me lower and lower and sometimes free mortgage money for a period of time. I take advantage of that. Less-educated people do not go out and actively seek and test the market for different rates.

Is there an active program such as the one for people who are more economically advantaged, presumably better educated and better financial risks, a similar program for people who are in the subprime market? Does anybody send them a solicitation and say, hey, we reviewed your credit, the way they did mine, and you are pre-approved to get such-and-such an interest rate, and please fill out the application or call and we will do it over the phone in 22 minutes? Does such a program exist for those people? Or is it just those of us who are fortunate?

Mr. CALHOUN. I think the industry information is clear that if anything there is more solicitation of loans in the subprime market. It is hard to believe given the volume in the prime market.

Mr. ACKERMAN. Is that solicitation for another loan or solicitation for a lower interest rate?

Mr. CALHOUN. It is solicitation typically for another loan, because again in the subprime market, most of these loans are originated by brokers.

Mr. ACKERMAN. I can appreciate that, because if it is only 3 years, everybody is looking for that business, because if it is being written at 9 percent or whatever, people are going to want to write 12 percent or whatever it is, 15 percent, write that business.

But my credit report gets reviewed by people with green eyeshades somewhere, and I get all these promotions. I know a lot of other people that do as well. It floods our mailboxes, and they are offering us a better deal. I am not asking you if they are getting another deal, because everybody wants to give them another deal if they are paying that rate. Statistically, it pays to make the bet.

But does anybody go to these people and say, hey, based on your credit report recently, you are a better risk and therefore we are going to offer you four points lower or three points lower?

Mr. CALHOUN. The challenge has been that the market has shifted and gotten turned on its head so that in these situations most of the money for the originator is being made in up-front fees. So the incentive, particularly since they know somebody else is going to come and try and sell another loan a year or 2 later is to try and get as much up-front fees and capture profit there, instead of having free market forces work that would compete to lower the interest rate. That is one of the reasons that we want the market to work better by having people compete on interest rates, and let lenders offer a rate that reflects the risk.

Mr. ACKERMAN. And the current system does not permit that?

Mr. CALHOUN. The current system turns it on its head and says the most successful lender is the one who can extract the most points at each lending.

Mr. ACKERMAN. That system basically locks these people, who tend to be more minority and poorly educated, into expending a greater portion of their income than anybody else in our society on their housing needs, although their housing needs might be much more modest. Is that accurate?

Mr. CALHOUN. Yes, Congressman.

Mr. ACKERMAN. Should there be something, and I am finishing up now, Mr. Chairman, should there be something in the counseling process which tells these people that if your credit position improves and if you make all your payments on time, that there is a reasonable possibility that when your loan comes to the end of its term that you will be able to get a better rate, and here is what you should do about it, or do we just tell them other things?

Mr. DEMONG. Congressman, I have actually seen some ads that Fannie Mae has done arguing that people can improve their credit if they take the certain steps.

Mr. ACKERMAN. Does this go out to those people specifically or is it advertising in the papers?

Mr. DEMONG. I have only seen it on television.

Mr. ACKERMAN. And that is Fannie Mae.

Mr. DEMONG. I think the point is that that education is always more valuable, and helping people better understand their own credit and their own abilities to improve their credit is very worth-

while. I know some of the industry has done that, with such programs as "BorrowSmart".

Mr. ACKERMAN. Last question, should we be looking at a requirement or encouraging the industry to when they make re-solicitations or initial solicitations of the people who are in the subprime market, that if their credit is good from that point on, if they are paying their bills, including their mortgage, and are not late, specifically to these people during the counseling process, and perhaps a written notice be required to them towards the end of their term that they should investigate that? Would that be helpful?

Mr. DEMONG. Again, as a professional educator, educating folks is always important. If it became a written notice, the point I would make is make sure it is easy to read and understand that it is there to help them.

Mr. ACKERMAN. Mr. Calhoun or Mr. Green or anybody?

Mr. CALHOUN. The mortgage process is inherently complex and can be easily manipulated. The time you need counseling is at or near the time of closing. That is why the North Carolina law, one of its most effective provisions has been to say, if you are going to get a very high-fee mortgage, that you should go to counseling at that point, get a certificate, and then go through with the mortgage if you want to. But almost invariably, what happens is they are advised they can get a better mortgage and they in fact do get a better mortgage rather than one of these very high-fee mortgages.

Mr. ACKERMAN. Mr. Green, any comment?

Mr. GREEN. No. The experience that we have had with investor education on the bond market side has been a very positive thing. So education is a good thing.

Mr. ACKERMAN. Indeed it is. With that, I thank the Chair.

Chairman NEY. I thank the gentleman, and thank the panel for your patience and participation, also our members for coming today, and Mr. Ackerman.

I have for the record some hearing enclosures. I have a Statement of the Coalition for Fair and Affordable Lending; a Statement of the Housing Policy Council; and a Statement of Freddie Mac which I would like to enter for the record, if there is no objection. Hearing no objection, I enter it for the record.

[The following information can be found on pages 117, 135 and 127 in the appendix.]

I would also like to note that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and place their responses in the record.

Again, I want to thank Chairman Bachus and most of all, all of you who came here today. Thank you.

[Whereupon, at 1:05 p.m., the subcommittees adjourned.]

A P P E N D I X

June 23, 2004

Opening Statement of the Honorable Bob Ney
Chairman, Subcommittee on Housing and Community Opportunity

Hearing on

"Promoting Homeownership by Ensuring Liquidity in the Sub-prime Market"

Wednesday, June 23, 2004

Today these two subcommittees meet to continue their investigation of the sub-prime mortgage market and its importance to consumers. Last year, Chairman Bachus and I began holding roundtables to discuss abusive lending practices, subprime lending, and how we can ensure credit availability for those who need and want it.

Last fall, we held our first joint hearing examining abusive lending practices. This spring we followed that by holding a hearing looking at the subprime lending market. For the first time in the predatory lending discussion we looked at the growing class of sub-prime borrowers and their role in the mortgage marketplace.

Today, we investigate another vital piece of the subprime mortgage market, the secondary market. The United States mortgage market is the deepest and most affordable in the world. Due to the evolution of unique funding structures for mortgages, Americans pay less for mortgages than almost anyone else in the world. As a result, this country has the world's highest homeownership rate.

However, the unique funding structure that has been long established for the prime mortgage market is far less mature for the subprime mortgage market. Only recently has it become common for a majority of subprime loans to be packaged and sold to investors. I believe that this evolution has led to lower and more uniform rates for subprime loans, saving consumers money while making credit more widely available. However, states and cities have begun passing laws that dramatically affect the availability of funds for subprime lenders. In a well-intentioned attempt to end abusive lending practices, some state and local governments passed laws extending liability for fraudulent origination practices to those in the secondary market that purchase the loan in a pool, but had no hand in actually writing the loan. These strict assignee liability laws threaten the availability of credit in the subprime market. Acting as a usury cap on mortgage lending, these laws effectively prevent people from receiving mortgages.

The recent case study on the problems with assignee liability is Georgia, where the state legislator passed an incredibly onerous law with strict assignee liability. This law led many secondary market players to withdraw from the Georgia market, drying up credit for many borrowers. The Georgia legislature passed a half fix to the problem that provided some lending opportunities, but we still don't know what will be the lasting affect of these predatory lending statutes on the availability of credit.

In order to better understand the impact of laws like Georgia's, this hearing will give our subcommittees a chance to hear from a distinguished group of witnesses on the availability

subprime mortgages. I think that this hearing is timely and important to this committee's duty of ensuring access to credit for Americans.

I look forward to hearing form our witnesses and I want to thank all of them for taking time from their busy schedules to be with us today. I now want to recognize my Ranking Member Mrs. Waters.

STATEMENT OF CHAIRMAN SPENCER BACHUS
JOINT HEARING OF SUBCOMMITTEES ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT AND HOUSING AND COMMUNITY OPPORTUNITY
"PROMOTING HOMEOWNERSHIP BY ENSURING LIQUIDITY IN THE SUBPRIME MORTGAGE MARKET"
JUNE 23, 2004

Thank you, Chairman Ney, for convening this third joint hearing of our two subcommittees to review issues related to the subprime mortgage lending industry in the United States.

In November of last year, we examined ways to combat abusive lending practices in the subprime lending market while also preserving access to mortgage loans for Americans with less than perfect credit records. Our second hearing, in March, focused on the characteristics of subprime borrowers and the advantages and disadvantages the market poses to the financial security of these consumers. Today's hearing, entitled "Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market," will explore the role that the secondary market plays in providing liquidity to the subprime lending industry and creating homeownership opportunities for Americans with less than perfect credit records.

As we have heard at our previous hearings, the growth in the subprime mortgage market over the past decade has been dramatic. In 1994, some $34 billion in subprime mortgages were originated. By 2002, that number had risen to over $200 billion.

Helping to fuel this growth has been the development of a robust secondary market for subprime loans. By selling loans that they originate into the secondary market rather than retaining them for their own portfolios, subprime lenders obtain fresh capital that can be recycled into new mortgage loans, enhancing liquidity in the subprime market and expanding the availability of credit to low and moderate-income borrowers.

As we have also heard at our prior hearings, some of the state and local anti-predatory lending laws enacted in recent years have included provisions that allow borrowers to sue secondary market purchasers of high-cost mortgages for abusive practices committed in the origination process, ever where these purchasers had no knowledge – and indeed, no way of knowing – of the underlying violations. These "assignee liability" provisions require purchasers of mortgage pools to determine as part of their due diligence whether the lender or mortgage broker involved in originating the individual loans that make up the portfolio misrepresented loan terms or engaged in other deceptive practices in dealing with the borrower.

Some have questioned the fairness of imposing liability on secondary market participants for violations that cannot possibly be detected through a review of the loan documentation on which their underwriting judgments are based. Credit rating agencies such as Standard & Poor's have simply refused to rate mortgage-

backed securities containing subprime loans originated in jurisdictions with particularly vague or open-ended assignee liability standards, leaving legitimate lenders with no way to securitize subprime loans, and significantly curtailing the availability of mortgage credit to low and moderate-income borrowers.

Last year, Chairman Ney and Congressman Ken Lucas introduced H.R. 833, the Responsible Lending Act, containing a number of new consumer protections and disclosures which are intended to serve as uniform national standards for combating predatory or abusive practices. On the question of assignee liability, Chairman Ney's bill amends the Home Ownership Equity Protection Act (HOEPA) so that purchasers of high-cost mortgages would face liability for violations committed by the loan originator "only if the violation . . . is apparent on the face of the disclosure statement or the underlying promissory note." This approach holds the possibility, in my view, of providing the secondary market with a measure of legal certainty that is lacking in many state and local anti-predatory lending laws. Such legal certainty is essential if the secondary market is to continue to serve as a vital source of liquidity for the subprime mortgage industry.

Let me close by saying that I am committed – as I think all of my colleagues on the Committee are – to finding ways to put an end to predatory lending while also preserving and promoting

access for all homebuyers to affordable credit. I again commend Chairman Ney for his leadership, both in presiding over these important hearings and in advancing creative legislative solutions to the predatory lending problem.

I look forward to the testimony of our witnesses, and I yield back the balance of my time.

STATEMENT OF THE HONORABLE WM LACY CLAY
Before the
Subcommittees on Housing and Community Opportunity and the
Subcommittee on Financial Institutions and Consumer Credit
"Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market"
June 23, 2004

Good morning Chairmen Ney and Baucus; Ranking Members Waters and Sanders; and distinguished witnesses. I thank the leadership of these subcommittees for scheduling this hearing on this important issue.

There is a very delicate balance that has to be achieved by legislation in the addressing of this issue:

Initially, we have to identify predatory lending and distinguish it from subprime lending. We have to eradicate predatory lending without destroying the subprime lending market. The subprime market is a great asset to all in the housing market when properly engaged by mortgage lenders and brokers.

We have to address the issue of "assignee liability" and put secondary lenders and investors in a fair position with that issue without compromising the ability of consumers/borrowers to be made whole after suffering from misrepresentations by lenders.

We have to craft language that will preserve the role of the state Attorneys General in the enforcement of predatory lending violations. The state Attorneys General must not have their roles preempted by federal legislation or regulation.

We must also be cognizant of the "Standard & Poor's New Rating Report". We must be very deliberate in our methods of addressing this issue and take pains to keep the market attractive for national and international investors who help to keep money available for the mortgages.

I look forward to the proceedings of this hearing and am sure that it will yield enormous benefit to the fight against predatory lending.

Mr. Chairman, I ask unanimous consent to insert my statement into the record.

June 23, 2004

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Housing and Community Opportunity
Joint Hearing entitled, "Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market"

I'd like to thank our subcommittee chairmen for calling this important hearing and for allowing us this opportunity to continue our discussion of issues related to the subprime mortgage lending market.

Since the early 1990s the subprime market has greatly expanded with just $34 billion in subprime mortgages originated in 1994 and $213 billion in 2002. This increase in subprime lending has given many American consumers the opportunity to realize their dreams of homeownership, despite their less than perfect credit.

While subprime lending has increased access to credit for many worthy Americans it has also, in some cases, enabled vulnerable populations to be targeted by abusive or "predatory" lenders. In response to such practices many states and localities have enacted "predatory lending" laws requiring new consumer disclosures, prohibiting certain terms, and creating new legal protections for borrowers who are victims of abusive lending practices.

In my home state of Ohio, the city of Cleveland passed a law restricting high loan rates and other subprime practices intended to prohibit "predatory" activities. However, as was detailed in a Cleveland Plain Dealer article, this law only served to drive lenders out of Cleveland during the 14 months before it was found unconstitutional. Residents who had less than perfect credit found it almost impossible to find a home loan in the city of Cleveland.

I am happy to be an original cosponsor of HR 833, the Responsible Lending Act of 2003, legislation to establish a federal standard to combat unfair and deceptive practices in the high-cost mortgage market, establish a consumer mortgage protection board, and

establish licensing and minimum standards for mortgage brokers. This legislation would establish a balanced federal standard to combat "predatory" lending practices while maintaining access for consumers to the subprime market.

Thank you again, Mr. Chairman, for calling this important hearing and I look forward to an informative session.

OPENING REMARKS OF THE HONORABLE RUBÉN HINOJOSA
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON HOUSING
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
"LIDUIDITY IN THE SUBPRIME MARKETS"
JUNE 23, 2004

Chairmen Ney and Bachus and Ranking Members Waters and Sanders, today we discuss a very important issue, one that has a direct impact on my Hispanic constituents in the 15th district of Texas. Subprime lending is very common in my district. Unfortunately, most, if not all, of predatory loans are subprime loans. This will likely be discussed further during today's hearing.

Mr. Chairman, as we celebrate National Homeownership Month this June, all of us can take pride in the fact that America has the best housing finance system in the world – a system that provides consumers access to international capital markets, bringing investment dollars in from around the world to finance homes for Americans.

In recent years, America's robust housing market – which has buoyed economic recovery and fueled consumer confidence and consumption – has achieved new records in sales, housing starts and mortgage originations.

And yet this system that works so well for so many, doesn't work for everyone. The powerless are all too often forgotten in the halls of Congress.

While the national homeownership rate is above 68 percent – and nearly 76 percent for white, non-Hispanic families – only 50 percent of minority families own their homes. Only 22 percent of Spanish-language dominant Hispanic households know that it is not necessary to have a perfect credit rating to qualify for a mortgage – compared to 73 percent for the general population.

And only 39 percent of Spanish-language dominant households know that it is not necessary to have stayed in the same job for at least five years to get a mortgage – nearly 30 percent behind the general population.

We need to close these gaps, because in America today, homeownership means much more than shelter. It leads to community cohesion and community pride, and it tends to result in a reduction in crime in communities.

A study by the Consumer Federation of America revealed that while home equity represents 42 percent of net worth for homeowners in general, it is 63 percent for Hispanic Americans and 80 percent for low-income families.

Many residents in rural communities, such as those in my Congressional district, face tough obstacles: a lack of local mortgage lenders; poor credit quality; a lack of funds for downpayment and closing costs; and a shortage of home builders and developers. So we

are increasing our commitment to rural housing – both in Texas and throughout the country.

A large percentage of my constituents have poor credit histories, no credit histories or are, unfortunately, not very financially astute, which is why I have been promoting financial literacy throughout my district in collaboration with the FDIC and its Money Smart Program as well as with Freddie Mac and its CreditSmart Espanol program.

We are also attempting to improve housing conditions and affordability through the Congressional Rural Housing Caucus, of which I am the Chairman. The Caucus has already had its first staff level meeting with the Rural Housing Service of the United States Department of Agriculture, and the Caucus will be holding its second meeting, this time on a Member level, July 13th with Fannie Mae. The meeting will be open only to Caucus Members and/or their staff.

I encourage all of my colleagues to join this Caucus. Rest assured that predatory lending will be discussed at one, if not several, of the Caucus meetings.

I realize that today we are addressing liquidity in the subprime market as well as whether or not to promote federal preemption of state laws, some of which seem to have benefitted minorities.

I will be curious to learn how federal preemption of state laws on subprime mortgage loans will improve and augment minority homeownership. I am particularly interested in Mr. DeMong's findings since they seem to cite only one HUD study as evidence that federal preemption of state laws is the route to take.

Furthermore, none of the testimony I reviewed provided an adequate guide to, or definition of, "predatory lending." Consequently, we seem to be back to square one.

With that Mr. Chairman, I yield back the remainder of my time.

GARY G. MILLER
42ND DISTRICT, CALIFORNIA

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COMMITTEE ON FINANCIAL SERVICES

COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE

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Statement of Representative Gary Miller

Hearing on Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market

June 23, 2004

I thank Housing Subcommittee Chairman Ney and Financial Institutions Subcommittee Chairman Bachus for convening this important hearing on liquidity in the subprime mortgage market. This is a very important issue, particularly with the passage of state and local predatory lending laws, which have assigned liability to the secondary market.

As many of you have heard me discuss before, there is a housing affordability crisis in this country, particularly in my state of California. The California homeownership rate, at 56.9 percent in 2000, lags the rate for the rest of the nation by more than 10 percentage points. In fact, California has the highest home prices in the nation.

Housing finance is a vital component of homeownership. To foster homeownership in this country, we must eliminate abusive lending practices while preserving and promoting access to affordable mortgage credit. The best public policy to achieve this goal is for Congress to ensure that we have a fair, workable uniform national lending standard.

There is no question that some non-prime borrowers are subjected to abusive practices. This should be prevented. However, there also is no question that vast numbers of borrowers who are not victims of such practices can become victimized by poorly crafted "protective" legislation that restricts non-prime credit availability.

State and local anti-predatory lending laws are inconsistent, sometimes ineffective, and often arbitrary and unduly burdensome. This has the effect of limiting non-prime credit availability. These laws have forced the mortgage industry to restrict access to credit or exit entire market areas.

Congress needs to pass a balanced bill to provide uniform national standards for non-prime mortgage lending. This will ensure that all borrowers in all states receive the same adequate protections.

Purchasers of subprime mortgages on the secondary market must be liable for violations committed ONLY IF they knowingly purchase such loans. I believe H.R. 833, the Responsible Lending Act, which was introduced by Chairman Ney, and of which I am an original cosponsor, strikes this important balance and I look forward to the Committee acting soon on this important legislation.

I welcome the witnesses to the Committee and look forward to their testimony to help us better understand the role of the secondary market in the mortgage process.

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Statement for the Record
Congresswoman Nydia M. Velázquez
Joint Hearing – Subcommittees on Financial Institutions and Housing
6/23/04

Thank you Mr. Chairman. I appreciate you holding this hearing today and continuing to pursue the important issue of predatory lending and the subprime market.

As we all know, increasing homeownership is one of the most laudable goals a community and, indeed, a nation, can pursue. It opens up the doors of opportunity to families in all of our neighborhoods and ensures that generations have the security they need to build successful lives. Predatory lending is a threat to this pursuit, forcing families to declare bankruptcy because of their inability to pay their mortgage, oftentimes breaking them apart and crushing their dreams for economic stability and success.

At the same time, acquiring a home through the use of a subprime loan offers families a great opportunity -- one they may not otherwise have because of inconsistent credit histories or lack of capital. Attempting to balance these two issues is what we will begin to do today. This will be the start of a longer discussion and debate on the issue and, hopefully, will lead to some positive solutions on how to protect home buyers across the nation.

Predatory loan practices such as financing excessive fees, inflating interest rates, and making loans without regard to the borrower's ability to pay devastate already fragile communities. These practices force concentrated areas of low-income families into foreclosure. Furthermore, many families that fall victim to predatory lending qualify for loans at significantly lower rates.

Over the past few years, states have moved to curb predatory lending, enacting legislation to prevent unscrupulous lenders from taking advantage of minorities, seniors, and other vulnerable first-time homebuyers. There is, however, a need to balance the desire to give states and localities, who may know the needs of their communities best, the power to enact legislation, and the need for an efficient federal banking system that encourages the free flow of capital to these communities.

Addressing predatory lending is critical to the growth of homeownership in our nation. As all of us here must continue to work together to find viable solutions to this issue, we must keep in mind that our decisions affect millions of families across the country.

I know that what we hear today will be insightful and will help us all get a better picture of what homebuyers and lenders are facing – and will, no doubt, lead us in the direction of making meaningful change in the area of predatory lending.

Statement of Congresswoman Maxine Waters
for the Joint Subcommittee Hearing on Assignee Liability
and the Secondary Market for Subprime Mortgage Lending

June 23, 2004
2128 RHOB
10:00 A.M.

Thank you, Chairman Baucus and Chairman Ney. You have chosen to entitle this morning's hearing, "Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market." I believe that the premise behind this title is mistaken, as it appears to assume that there is some sort of crisis in liquidity in the subprime mortgage market when the facts seem to suggest that there is no such crisis.

We have liquidity in the subprime market. There is nothing more that we need to ensure. What I believe we do need to ensure is that consumers seeking subprime loans are not subjected to abusive lending practices, like unreasonably high interest rates and costs. We also must ensure that these consumers are not subjected to deceptive marketing marketing practices that steer borrowers to subprime loans even when they qualify for conventional loans and that often result in loan terms that increase the risks of foreclosure.

Mr. Chairman, let me be clear about my concerns: My view is that we must not invent a crisis in sub-prime lending, where none exists, simply to lay a foundation for seeking federal preemption of state and local predatory lending provisions.

Beginning with North Carolina in 1999, some 29 states and at least 18 municipalities have enacted laws to address the problem of predatory lending. The majority of the state laws were enacted with the support of national and local consumer and community groups. Some of them provide for assignee liability beyond that which exists under the Home Ownership and Equity Protections Act (HOEPA).

Mr. Chairman, it is clear that HOEPA's effectiveness in preventing abusive lending has been limited. There are many abusive loans that HOEPA simply does not reach.

Mr. Chairman, states and municipalities need to remain free to regulate abusive loans not reached by HOEPA that are violative of state or local law. I believe that any person who purchases or is assigned a high-cost loan should be subject to all claims and defenses that the consumer could assert against the original lender.

Mr. Chairman, as a general proposition, I do not support federal preemption when it comes to financial services issues, because, almost invariably, the effect of such uniform standards, at least for Los Angeles, is a reduction in the protections for my constituents. Whenever we adopt federal standards, I believe that such standards should set the floor, not the ceiling on the protections available to consumer.

If states and municipalities deem it proper to offer additional protection to their residents, they should be free to do so. I, for one, have no interest whatsoever in preempting state and local predatory lending laws, such as those that have been enacted in Los Angeles, in San Francisco, in Oakland, California, and in many other jurisdictions.

Mr. Chairman, as HUD has noted, subprime loans were five times more likely in black neighborhoods than in white neighborhoods, and homeowners in high-income black areas were twice as likely to have subprime loans as homeowners in low-income white areas.

Mr. Chairman, it certainly is appropriate and worthwhile to examine whether assignee liability provisions in certain state and municipal anti-predatory lending statutes are having an impact on the secondary market for subprime mortgages and the general availability of credit for subprime lending.

Yet, when, according to the trade publication, Inside B&C Lending, we had an estimated total of $332 billion in origination volume in the subprime market in 2003, a 55.9% increase over 2002 volume, it is difficult to believe that the subprime market needs any relief from state and local predatory lending provisions in order to prosper. According to Inside B&C Lending, the top 25 subprime lenders had a 61.4% increase in their volume in 2003.

The evidence would have to be extremely compelling that state and local predatory lending laws were interfering with the availability of subprime loans to qualified borrowers before I could even consider supporting preemption. On these facts, I just don't see it. So our witnesses bear a heavy burden of persuasion if they want to convince me that any preemption of state and local predatory lending ordinances is required.

I look forward to the testimony of our witnesses. Thank you, Mr. Chairman.

# # #

Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Housing and Community Opportunity
Joint Hearing Entitled "Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market"

June 23, 2004

Prepared Testimony of Michael D. Calhoun,
General Counsel
Center for Responsible Lending

Chairman Bachus and Chairman Ney, Ranking Member Sanders and Ranking Member Waters, thank you for the opportunity to testify today on the issue of liquidity in the subprime market. I am here representing the Center for Responsible Lending (CRL), which is a nonprofit, nonpartisan research and public policy organization working on predatory lending issues and an affiliate of Self-Help. My positions with both CRL and Self-Help provide me with both the perspective of an experienced lender and an understanding of market failures inherent in today's subprime home lending industry, along with the impact of these failures on homeowners and policy solutions that address these failures.

I'd like to emphasize three points.

- ***Assignee liability provisions in state predatory lending laws focus on those loans at highest risk of abuse***. These provisions provide that families with high-cost loans who are injured by illegal acts have a remedy to protect their homes. Standard & Poor's adopts this view by requiring extra credit enhancement in states with predatory lending laws for high cost loans only, leaving the rest of the market unchanged.[1]

- ***Provisions against flipping of loans have provided an essential borrower protection without disrupting the secondary market***. Prohibitions on flipping prevent repeated abusive refinancings of loans that do nothing more than generate fees for lenders and strip the homeowner's equity. North Carolina has had this provision for all home loans for four years, and it has not generated a single filed case, nor has it disrupted the secondary market.

- ***State laws have not hampered subprime lending's growth; volume and liquidity in the subprime mortgage market are expanding rapidly***. In 2003, subprime lending and securitizations both increased by more than 50 percent. The first quarter of 2004 had 70% year-to-year growth. State laws to protect families from predatory lending are not stifling this exploding market.

[1] S&P also required credit enhancement for New Jersey loans in the "covered loan" category, those that have between 4% and 5% in fees. While this category represents less than 2% of the market, legislation that deletes the covered loan category is pending in the New Jersey legislature and is likely to pass by the end of the month.

Self-Help is a North Carolina-based nonprofit community development lender that includes a credit union and a loan fund. Initially founded to improve access to credit for communities that could not obtain the financing they needed from traditional financial institutions, we are committed to the idea that ownership allows people to improve their economic position and provides communities with a solid foundation on which to grow and prosper. In particular, we have found that homeownership is the bedrock for economic security, as homeownership has been the primary way for families to build wealth. In the U.S. today, one-half of all homeowners hold at least 50 percent of their net worth in home equity.[2] And home equity comprises over 60 percent of the net worth of minority and low-income families.[3] This equity is used by families to send children to college, start new businesses, or weather crises such as job loss or extended illness.

Self-Help has provided more than $3.5 billion in financing to borrowers in 47 states since its founding in 1980, and has enabled more than 38,000 families to become homeowners. Through our commercial loans, we have created or maintained approximately 20,000 jobs, allowed child care providers to create space for 20,000 children, and enabled more than 9,000 students to attend public charter schools. Because we seek to serve those who have traditionally been denied access to credit, Self-Help's loans go disproportionately to women, African Americans, Latinos, and rural borrowers. ***Our overall loan loss rate is less than one-half of one percent per year, and our assets have grown to almost $1 billion.***

Self-Help's Secondary Market Program is a major component of our home lending work. Through the program, Self-Help buys packages of nonconforming loans from banks in return for the banks' commitment to re-lend the money to an equivalent number of low-wealth home buyers in the future. This program, which has been in place for ten years, has been tremendously successful, and has grown at a rapid pace. We have financed over $3.1 billion of loans to 36,500 families across the country through thirty lenders. Forty-one percent of the program's home loans had been made to minority families, 39% were made to female heads of household, and 21% of the loans were made to rural families. Additionally, these programs are reaching working-class families. The average income of the homebuyers is 64% of the relevant area median income. Losses have been well below one-half of one percent a year. Our program has also enabled us to develop a deeper understanding of the complexity of the secondary market and the issues that both lenders and borrowers face in today's home lending market.

Given our experience with mortgage lending, we have been surprised to hear concerns regarding liquidity and the availability of credit in the subprime market. Even while much of the economy has experienced bumps in recent years, the mortgage market has boomed, driven in part by the continued expansion of the subprime market. Unfortunately, the incredible growth of the subprime market has corresponded with an increase in abuse that has become a crisis for American families. The prevalence of abusive loan terms and lending practices in the subprime market have not only limited the equity-building potential for homeownership, but have led families to lose their homes and their accumulated life savings. The secondary market for subprime loans has encouraged such abuse, creating incentives for lenders to charge excessive

[2] See, e.g., Joint Center for Housing Studies of Harvard University. State of the Nation's Housing 1997: p.18.
[3] "Net Worth and Asset Ownership of Households, 1998 and 2000," at 15 tbl. I (U.S. Census Bureau, p70-8, May 2003).

fees and take advantage of vulnerable borrowers, and failing to engage in basic due diligence that could prevent abuses from taking place.

Self-Help and others in North Carolina first became familiar with the dangers of the subprime market in the 1990s, when we began to see borrowers come through our doors in search of help in staving off foreclosure. To our dismay, abusive terms in their existing loans routinely prevented us from refinancing their loan because all of their equity had been stripped by these abusive terms. We recognized that unscrupulous lenders were taking advantage of vulnerable homeowners to strip equity and steal hard-earned wealth, using terms of credit that were not commensurate with risk-based pricing.

In response, Self-Help joined with a remarkable coalition of bankers, credit unions, mortgage brokers, mortgage bankers, consumer advocates, the NAACP, AARP, and other community organizations to develop a state law with strong standards that would preserve the important benefits of the subprime market while weeding out the worst abuses. The resulting anti-predatory lending law, enacted in North Carolina in 1999, was the first in the nation, and its success continues to be a model for efforts in other parts of the country.

Since enactment of the law, Self Help has established an affiliate, the Center for Responsible Lending (CRL), a nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families. CRL draws on Self-Help's experience as a lender in advocating common-sense approaches to market failures and lender abuses that harm homeowners--and those who want to become homeowners--in their pursuit of security and opportunity.

Based both on our experience as a lender and our research into the abuses that impact low-wealth families, I hope today to address your concerns about the availability of credit in the subprime market. I also wish to bring to your attention the serious harms that abuses in this market have created, and to explain how North Carolina and other states have successfully addressed these issues while maintaining a vibrant market. I applaud your concern about the impact of lending practices on subprime borrowers, but hope that you will conclude that Congress could best respond by supplementing the important work that is taking place at the state level and supporting strong standards that promote responsible lending throughout the mortgage market.

I. The subprime market and the secondary market for subprime loans continue to grow at a rapid pace.

"The subprime mortgage business had one of its best years ever in 2003."[4]

The "subprime" market is intended to serve those who do not qualify for "prime" loans, primarily due to impaired or limited credit histories. To account for less-than-stellar credit, responsible subprime lenders charge slightly higher interest rates to compensate for the increased risk associated with their lending activities. Subprime home loans are typically packaged and

[4] *Subprime Mortgage Loans* 2004, p.5, SMR Research Corporation, January 2004.

sold to investors in the secondary market, which in turn provides subprime lenders with a source of capital with which to make additional loans.

There is no evidence that changes in mortgage laws at the state level have had a deleterious effect on the subprime market, which has continued to grow at an astonishing pace. ***Both subprime lending and the securitization of subprime loans increased by over 50 percent in 2003 over 2002*** – volume increased to $332 billion from $213 billion, while the issuance of subprime securities rose to $203 billion from $135 billion.[5] In 1994, by contrast, subprime lenders securitized just $10 billion worth of home equity loans.[6]

Mortgage industry forecasts have concluded that subprime lending will continue to increase in 2004.[7] At a recent MBA Subprime Lending Conference, the chief economist of the Mortgage Bankers Association noted that subprime lending is "much less interest rate sensitive" than the prime market and predicted that the sector could see growth in 2004 even if other sectors of the mortgage market falter.[8] Similarly, one industry publication reported, "Subprime lenders should continue to see strong demand for their product in the secondary market this year, analysts predict."[9] This prediction has proven true for the first quarter of 2004, with the market growing an additional 70.3 percent, on average, over the prior year's first quarter.[10]

II. Predatory lending abuses have created a crisis for American families.

The subprime market is largely a market for refinance loans -- approximately three-quarters of subprime originations in 2001 and 2002 were refinances[11] -- which present unscrupulous actors with opportunities to strip homeowners' built-up equity. Unfortunately, the combination of tremendous growth in subprime lending, the lack of standards for this rapidly growing industry, and subprime borrowers' frequent lack of financial sophistication has created an environment ripe for abuse. While by no means are all subprime loans predatory, almost all predatory loans are subprime. As a result of the growth of subprime lending, the pressing issue today is no longer the availability of credit in America's communities. Rather, the debate has shifted to the terms on which credit is offered.

Predatory mortgage lending is now epidemic, costing U.S. families an estimated $9.1 billion each year in lost homeowner equity, back-end penalties, and excess interest paid.[12] Abusive practices include stripping equity from homeowners through excessive fees; steering homeowners into unnecessarily expensive loans on the basis of race, ethnicity, age, and gender; and interfering with the ability of homeowners to protect their homes from foreclosure with

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[5] Inside B & C Lending. Jan. 12, 2004, p.3 and Feb.9, 2004, p.1.
[6] Cathy Lesser Mansfield, "The Road to Subprime 'HEL' was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market," S.C. Law Review, v51, n3 (2000), 473-587.
[7] *Subprime Mortgage Loans 2004,* p.15, SMR Research Corporation, January 2004; *Subprime Lenders Shatter Records in '03 and Get Set for More in '04,* Inside B&C Lending, February 9, 2004.
[8] Lew Sichelman, National Mortgage News, "Line Between Prime and Nonprime Gets Blurry," May 24, 2004.
[9] Inside B & C Lending. Jan. 12, 2004, p.3.
[10] Inside B&C Lending, June 14, 2004, p.1-2.
[11] SMR Research Corp., Analysis of 2001 and 2002 Home Mortgage Disclosure Act data.
[12] Stein, Eric. "Quantifying the Economic Cost of Predatory Lending", Coalition for Responsible Lending (2001) (available at http://www.predatorylending.org/pdfs/Quant10-01.PDF).

legitimate defenses. We know from experience that predatory lending robs families of the home equity wealth that could otherwise be used to send children to college, start small businesses, weather crises such as unanticipated medical expenses, and enjoy some measure of security in old age. Even worse, because predatory lending can lead to increased foreclosures across a neighborhood, abuses have a devastating impact on communities.

Examples of some of the worst abuses include:

1. ***Excessive points and fees***. Points and fees are costs to borrowers that are not directly reflected in interest rates. Excessive points and fees are frequently the hallmark of a predatory loan, and they can disguise the real cost of credit when they are financed rather than paid outright at a loan closing. The problem for borrowers is that, while they may refinance out of a loan that has an interest rate that does not properly reflect their risk, they cannot recover fees, ever. Instead, those fees are financed into the loan amount and are repaid from the homeowners' equity when they refinance. Furthermore, in the subprime market, fees are not advertised in a consistent way, and homeowners may not learn the total fees they are being charged on a loan until the day of closing, if at all. Thus, comparing lenders' fees is more difficult than comparing interest rates; homeowners would have an easier time "shopping" for loans if lenders took their compensation in the form of interest rates rather than fees.

2. ***Abusive broker kickbacks.*** Research suggests that brokers originate approximately half of all subprime refinance loans,[13] and that these brokered loans are particularly expensive for African American and Latino homeowners.[14] Most borrowers do not understand that mortgage brokers generally do not have legal duties to find them the best loans available. Because borrowers are typically unaware of the best available interest rate for which they qualify, yield spread premiums[15] function as kickbacks that encourage mortgage brokers to steer consumers into particularly costly loans. As one study recently put it,

> Disturbingly, the tendency of brokers to charge excessive fees or present misleading information is not 'corrected,' but rather priced in the market. . . In a world in which the broker is detached from the lender and the lender is detached

[13] "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," Joint Center for Housing Studies, Harvard University (March 9, 2004), p.4.

[14] See, e.g., Prepared Statement of Prof. Howell E. Jackson Finn M.W. Caspersen and Household International Professor of Law and Associate Dean for Research and Special Programs Harvard Law School, ***Hearing Before the Senate Banking, Housing and Urban Affairs***, 107th Cong., January 8, 2002, ***available at*** http://banking.senate.gov/02_01hrg/010802/jackson.htm (finding that "mortgage brokers charged two racial groups - African-Americans and Hispanics - substantially more for settlement services than they did other borrowers. For African-Americans, the average additional charge was $474 per loan, and for Hispanics, the average additional charge was $580 per loan.")

[15] Brokers can be paid for their services directly by borrowers, frequently as a percentage of the total loan amount and through other direct fees, including application fees. Brokers are also frequently paid indirectly by the lender/investor through a "yield spread premium" based on the yield of the mortgage. This premium reflects the difference in price between what a lender is willing to pay the broker for a home loan made to the borrower at market rate and the value of a mortgage originated at a higher interest rate. For example, if the borrower should receive a 7% loan and instead receives a 7.75% loan with a prepayment penalty, the lender might pay the broker $103,000 (rather than the typical $100,000) for a $100,000 loan.

> from the investor, market feedback loops are broken, or at best are slow to operate. Rather than work to root out abuse under the current industry structure, some buyers pay more, brokers earn a premium return, and investors are compensated. . . . The result is that the impact of foreclosures to borrowers and communities is ignored by the capital markets.[16]

Those looking to increase their own compensation at the expense of homeowners may choose their targets in a manner that takes advantage of more vulnerable borrowers. A recent study of older borrowers who obtained mortgage loans (both prime and subprime) concluded:

> [B]orrowers with broker-originated loans were much more likely to report that they did not initiate the contact about the loan, and they relied more on the broker than the borrowers with lender-originated loans. In addition, borrowers with broker-originated loans were more likely to report having received loans with less favorable terms such as prepayment penalties and points paid upfront than borrowers with lender-originated loans.[17]

3. ***Charging prepayment penalties on subprime loans***. Prepayment penalties on subprime loans trap borrowers in high-rate loans, often leading to foreclosure and bankruptcy. Prepayment penalties prevent borrowers from using the subprime market as a bridge to conventional financing as the borrowers' credit improves. While prepayment penalties are rare in the conventional market, a large majority of subprime loans contain these terms. Prepayment penalties may vary with respect to how large they are (usually calculated in terms of a number of months' interest) and how long they remain in effect. Some of the most pernicious penalties remain in effect for five full years and are calculated as six months' interest on any prepaid amount that exceeds 20% of the loan. In the context of a subprime loan with an interest rate of 12%, this means that the prepayment penalty amounts to approximately 5% of the loan balance. For a $150,000 loan, this fee is $7,500, or equal to the median net worth of African American households in 2000. This is a very steep penalty for simply paying off a loan "too quickly."

4. ***Flipping borrowers through fee-loaded refinancings***. Abusive lenders refinance subprime loans over and over, each time charging fees that reduce home equity and each time leaving the borrower worse off than when he or she started. North Carolina research found that abusive lenders flip one in ten Habitat for Humanity borrowers from their interest-free first mortgages into high interest loans.[18] Some lenders set borrowers up by selling them bad loans packed with unexplained terms; when balloon payments come due or when interest rates on the loans rise, these borrowers have little choice but to

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[16] "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," Joint Center for Housing Studies, Harvard University (March 9, 2004), p.33 &44 (citation omitted).

[17] Kellie M. Kim-Sung and Sharon Hermanson, "Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans," AARP Public Policy Institute (January 2003).

[18] See "Overview of Habitat for Humanities Refinances" (Coalition for Responsible Lending, Dec. 9, 1999), under Studies at http://www.responsiblelending.org. Since 1999, Habitat has instituted additional protections against flipping.

refinance. Loan flipping is this practice of refinancing a mortgage loan without benefit to the borrower, usually in order to extract additional origination fees, closing costs, points, prepayment penalties, or other charges.

For abusive lenders, loan flipping can be an alternative to making "high-cost" loans, or loans with high interest rates or points and fees. Fees are not packed into loans all at once, but rather accumulate over the course of multiple transactions. By flipping loans, unscrupulous lenders can avoid high-cost loan thresholds while still racking up exorbitant fees.

5. ***Single-premium credit insurance***. Credit insurance (in the form of life, accident, health, or other forms of insurance) is paid by the borrower to repay the lender in the event the borrower dies. When paid for up-front, this insurance does nothing more than strip equity from homeowners. After North Carolina banned this practice, the industry largely eliminated single-premium credit insurance.

The stories of individuals who have been callously preyed upon by predatory lenders could fill volumes. In 1998, Self-Help learned about such abuses first-hand, when a middle-aged African American home loan borrower broke into tears in our CEO's office. He told us that his wife had died three years before, leaving him to care for their six-year old daughter. He desperately wanted to hold onto his house, saying, "This house is more than a home. It is also the physical memory of my daughter's mother." For ten years, he said, he had tried to refinance a home loan he had taken at 14% interest; he insisted that the lender would not let him pay off the loan. The loan documents showed that this man's loan of $29,000 had been inflated with $15,000 in fees, including credit insurance and other unnecessary costs. The lender would not tell him—or Self-Help -- the pay-off balance. We soon discovered that the problem was larger than one loan. This same lender was making 18,000 mortgage loans per year in North Carolina alone. The story is not an isolated example-- we have seen the dynamic play out time and time again, and the United States Departments of Treasury and Housing and Urban Development have documented these abuses in a joint report.[19]

Because predatory lenders are known to target certain neighborhoods, the odds are good that one victim of predatory lending lives down the street or around the corner from another. In this way, whole communities are affected, especially when foreclosures become rampant. For instance, according to the Mortgage Bankers Association, nearly 16 percent of Ohio's subprime loans were in foreclosure last year at this time. This was thirteen times the rate of foreclosure in conventional loans.[20] New evidence from the Woodstock Institute in Chicago shows that recent increases in foreclosures have been fueled in large part by increases in subprime home lending in the last half of the 1990s. In addition to finding subprime lending "the dominant driver" of increases in foreclosures, the authors note that the impact of foreclosures is most keenly felt in "modest-income neighborhoods where foreclosures more often lead to abandonment and blight"

[19] U.S. Department of Housing and Urban Development & U.S Department of the Treasury, "Curbing Predatory Lending" (June 2000) (available at: http://www.hud.gov/library/bookshelf18/pressrel/treasrpt.pdf).
[20] *See*, "Pace Quickens on Home Foreclosures in Ohio", The Columbus Dispatch (March 25, 2003).

and that those costs are "borne by entire communities, not just by the lender or borrower."[21] Key findings from the report include the following:

- From 1995 to 2002, foreclosure starts in the Chicago area grew 238 percent.
- Increases in the number of subprime loans resulted in a 22 times larger growth in the number of foreclosures than identical increases in prime lending, controlling for unemployment, changes in population, home values, family income, and minority population concentration.
- Census tracts experiencing an increase of 100 subprime loans over this time period experienced 29 percent more foreclosures after controlling for "neighborhood demographics and economic conditions."

A recent study of foreclosure records in one Kentucky county directly links foreclosure to predatory loan terms. In a study conducted for the Louisville Urban League, court documents were examined for more than 1,500 mortgage foreclosures that resulted in court-ordered auctions between January 2000 and December 2002. This examination resulted in the conclusion that "About one-third of those foreclosures appeared to involve loans with predatory characteristics. This suggests that predatory lending probably accounts for a significant part of the growing foreclosure rate in Jefferson County."[22] Of the loans with predatory terms, 73 percent had prepayment penalties combined with high interest rates (defined as at least 4 points higher than the 30-year Treasury rate) and 29 percent had balloon payments.[23]

While we might expect some elevation of default rates in the subprime market, the statistics documenting Self-Help's experience with lending to borrowers with blemished credit and low incomes (including our loss rate of no more than 0.5 percent per year) suggest that foreclosures in the subprime market cannot be explained solely by borrower behavior. Rather, we must recognize that abusive lending pushes borrowers past their limits and imposes extensive costs in our communities.

III. The North Carolina anti-predatory lending law has protected the state's vibrant subprime lending market, while driving out bad loans.

When Self-Help helped champion a state anti-predatory lending law in 1999, we pushed for provisions that would encourage lenders to limit fees and reflect credit risk accurately in interest rates. When the cost of credit is reflected in rates rather than fees, shopping is much easier for homeowners—and homeowners can also rectify mistakes through refinancing. The North Carolina law—passed virtually unanimously with the support of industry, consumer groups, and civil rights organizations--discourages unfair and abusive fees and prohibits the flipping of loans solely for fee generation purposes. Because of the law, in North Carolina today, the best defenders of borrowers from excessive interest rates are responsible lenders eager to refinance them to an appropriate rate.

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[21] Immergluck and Smith, Risky Business -- An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures, Woodstock Institute, March 2004.
[22] Steve C. Bourassa, "Predatory Lending in Jefferson County: A Report to the Louisville Urban League," 2 (Urban Studies Institute, University of Louisville Dec. 2003).
[23] Id.

Empirical research shows that the North Carolina successfully addressed abusive practices and simultaneously has allowed the subprime lending market to thrive.

A. The North Carolina law has decreased the incidence of equity-stripping loan terms.

CRL estimates that the new law saved consumers at least $100 million—in its first year—by preventing predatory loan terms that would have been expected to occur in the law's absence.[24] After analyzing the effects of North Carolina's law on the home mortgage market, researchers from the University of North Carolina concluded that the law has had a particularly significant impact on abusive refinances. More specifically, the UNC study noted a decline in the incidence of subprime home refinance loans containing prepayment penalty terms that exceed three years. In fact, there was a 75 percent decline in North Carolina, compared with a 30 percent increase nationally in extended prepayment penalty loans. In addition, the authors found a decline in subprime balloon payments and loan-to-value ratios of 110 percent or more. The study appropriately viewed such loans as of little or no benefit to the borrower and therefore as a subset of flipping. ***"Although the total volume of subprime originations in North Carolina declined, the number of home purchase loans was unaffected by the law. While refinance originations did fall, about ninety percent of the decline was in predatory loans."***[25]

In a separate finding, the UNC researchers also noted evidence that the North Carolina law resulted in a reduction in the "steering" of borrowers to loans with a higher price than that justified by their credit history. Subprime loans to borrowers with credit scores above 660—those who could more easily qualify for low-cost conventional loans—declined by 28 percent. According to HMDA data, overall loans by primarily prime lenders increased by 40 percent in the state from 2000 to 2001.

B. The North Carolina flipping provision successfully balances concerns of the market and borrowers.

The UNC findings regarding a reduction in abusive refinances are particularly significant, because a crucial component of North Carolina's landmark legislation is its prohibition against loan flipping . Specifically, the North Carolina forbids "knowingly or intentionally" refinancing a home loan that does not provide the borrower with a "reasonable, net tangible benefit," considering "all of the circumstances."[26] The NC standard is a compromise that favors both homeowners and lenders for three reasons:

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[24] Ernst, Keith, John Farris, and Eric Stein, "North Carolina's Subprime Home Loan Market After Predatory Lending Reform", Center for Responsible Lending (August 2002) (available at http://www.responsiblelending.org).

[25] R. Quercia, M. Stegman, & W. Davis, "An Assessment of the Impacts of North Carolina's Predatory Lending Law" (forthcoming Fannie Mae Foundation Housing Policy Debate), p.26. See "STUDY: NC Predatory Lending Law Cuts Abuses, Does Not Dry Up Credit for Borrowers", Center for Community Capitalism June 25, 2003 press release (available at http://www.kenan-flagler.unc.edu/News/DetailsNewsPage.cfm?id=466&menu=ki).

[26] "No lender may knowingly or intentionally engage in the unfair act or practice of 'flipping' a consumer home loan. 'Flipping' a consumer loan is the making of a consumer home loan to a borrower which refinances an existing consumer home loan when the new loan does not have reasonable, tangible net benefit to the borrower considering

- The NC standard provides incentives for lenders to reduce the incidence of flipping by more closely monitoring the underwriting and origination of refinance.
- At the same time, the "knowing or intentional" scienter requirement discourages potential litigants from bringing frivolous claims.
- In addition, the requirement that the trier of fact specifically review "all of the circumstances," including "the borrower's circumstances," makes it impossible for a claim to be asserted as a class action, since borrowers have differing circumstances.

The North Carolina provision also strikes the right balance by being neither over- nor under-inclusive. It allows lenders to use their knowledge of the market to develop standards for compliance, and avoids setting strict rules that would constrain the ability of lenders to make refinance loans that may be appropriate in one context, and of little value to the borrower in another. In reality, financial professionals are already accustomed to complying with broad and flexible standards of conduct in their business, such as unfair trade practice laws, the suitability standard governing investment advice[27], and the standard of liability for "churning" in the securities industry.[28]

Significantly, while the North Carolina flipping provision has been successful at reducing flipping abuses, it has not led to frivolous litigation in connection with refinance transactions. In a recent review of relevant filings in North Carolina District and Superior Courts, Federal District Courts, and U.S. Bankruptcy Courts against the nation's top 10 subprime lenders over the five-year period since the North Carolina law became effective (1999-2004), ***the Center for Responsible Lending identified no instances in which a borrower has alleged flipping since the North Carolina anti-predatory lending law became effective***. Given the scope of the review performed, this suggests that exceedingly few, if any, flipping claims are being alleged against subprime lenders in NC. (See "Flipping" Prohibitions in N.C. Elicit No Substantial Litigation," attached at Appendix A.).

C. The North Carolina law has improved the operation of risk-based pricing in the prime market and has allowed for the continued widespread availability of credit.

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all of the circumstances, including the terms of both the new and refinanced loans, the cost of the new loan, and the borrower's circumstances. . . ." N.C. Gen. Stat. § 24-10.2(c) (1999).

[27]For example, Rule 2310 of the NASD's Rules of Fair Practice sets a broad "reasonable grounds" and "reasonable efforts" standard in determining the suitability of a broker's recommendation to a customer and puts the obligation on the broker or company to evaluate the transaction. It provides that "[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situations and needs." Further, brokers must make "reasonable efforts to obtain information concerning" the customer's financial and tax status, investment objectives, and such other information.

[28] Churning occurs when a broker abuses his customer's confidence by excessively trading the customer's account in order to generate commissions. E.g., Deborah Travis, Comment, Broker Churning: Who is Punished? Vicariously Assessed Punitive Damages in the Context of Borkerage Houses And Their Agents, 30 Hous. L. Rev. 1775, 1778-79 (1993); Section 10 of the Securities Exchange Act of 1934 (the 1934 Act) prohibits churning as a form of broker-dealer fraud by making it unlawful for "any person . . . to employ . . . any manipulative or deceptive device or contrivance in contravention" of any rule "the Commission may prescribe as necessary or appropriate to the public interest or for the protection of investors." 15 U.S.C. § 78j (1982). See also Rule 10b-5, promulgated under section 10(b) of the 1934 Act.

Finally, it is clear that credit continues to be widely available in North Carolina in the nearly five years since the law went into effect. The UNC study also found that, after the law was fully implemented, North Carolina's mean origination interest rates were consistent with corresponding national rates and actually increased slightly less than the national average increase. One would have expected that rates would rise more than elsewhere since the intention of the law was to clamp down on fees and shift lender compensation to rate. This result suggests that the fees being charged before the law's implementation were not genuinely priced to account for the risk of default, but rather functioned as a vulnerability tax on North Carolina families.

Additionally, the UNC study found that home purchase loans to borrowers with credit scores below 580, those whose only option is subprime, more than doubled after the law was fully implemented, compared with an increase of 62 percent nationally. Although a reduction in steering led to a decrease in refinance loans to borrowers with higher credit scores, such loans to borrowers with credit scores below 580 increased by 18.5 percent in NC after the law. While this increase was at a lower rate than the country as a whole -- since abusive loans were not made in the state -- it demonstrates that the market continues to be available to those who need it most.

While the most rigorous examination of North Carolina's subprime market, the UNC study does not stand alone. A leading industry trade journal, *Inside B & C Lending*, reported that top North Carolina subprime lenders "continue to offer a full array of products for borrowers in North Carolina—with little or no variation in rate" compared to other states.[29] A recent Morgan Stanley & Co. survey of 280 subprime branch managers and brokers found that tougher state laws, including North Carolina's, have not reduced subprime residential lending volumes.[30] In fact, 84 percent of the managers thought changed practices are having neutral to positive impact on volume because they make customers feel more comfortable and "lower points and less onerous prepayment penalties make the economic terms more attractive."

What the academic studies show is simply what lenders like us who operate in this state every day experience -- there is no shortage of credit available to borrowers across the state. Joseph Smith, North Carolina's Commissioner of Banks, has commented that "[d]uring the last twelve months, over seventy-five percent of formal complaints to [his office] ... have involved mortgage lending activities [but] .... [n]ot one of these complaints has involved the inability of a North Carolina citizen to obtain residential mortgage credit."[31]

In summary, the North Carolina law has been an unqualified success. As UNC Professor Michael Stegman reported, ***"[t]he North Carolina predatory lending law is doing what it was intended to do: purge the market of abusive loans without restricting the supply of subprime mortgage capital accessible to North Carolina borrowers with blemished credit records."***[32]

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[29] Inside B&C Lending. Lenders Will Try to Pin Down Effects of NC Mortgage Law. March 5, 2001.
[30] Morgan Stanley. 2002. Channel Check: Surprisingly Strong Subprime Growth. Diversified Financials. August 1.
[31] North Carolina Office of the Commissioner of Banks, Joseph A. Smith, Jr. letter to Comptroller John D. Hawke, Jr. (October 2, 2003) (available at http://www.banking.state.nc.us/reports/Hawke.pdf).
[32] Quercia at p.1. Although an industry-sponsored Credit Research Center (CRC) study claimed that the North Carolina law led to a decrease in access to credit for low-income borrowers, that conclusion should be viewed with significant suspicion. The CRC study contradicts other industry reports and the weight of available evidence. The CRC study relies upon a limited data set from nine anonymous lenders that has not been made available for

IV. Assignee liability is critical to successful efforts to address predatory lending.

Since a majority of home loans are resold on the secondary market, assignee liability has proven a critical component of successful efforts to address predatory lending at the state level. Without liability for a person who has purchased the home loan (called an "assignee"), a family that has been the victim of a predatory loan cannot stop the foreclosure of their home even if the originator is solvent and well-capitalized. Instead, they end up losing their home, and then they must bring a separate action against the originator. This separate action can take years.

Assignee liability is even more important in light of the substantial involvement among mortgage brokers and other minimally capitalized originators who are frequently out-of-business before a homeowner recognizes a predatory loan.[33] Almost all mortgage loans are sold or otherwise assigned after closing, so the party collecting and enforcing the note is not the one that the borrower dealt with and who originated the loan. In fact, while very few home loans were brokered ten years ago, an estimated 65 percent are broker-originated today.[34]

Assignee liability also helps to protect responsible investors from misperceived risks and provides incentives for the market to police itself, curbing market inefficiencies. Without assignee liability, an unscrupulous lender can increase the value of the loans it sells by engaging in predatory practices and packing the loan with unnecessary fees, excessive interest rates and large prepayment penalties. The lack of assignee liability provides little incentive to purchasers of such loans to determine if the loans were originated illegally or are so out of line with market norms that they present a substantial likelihood of abuse.

Indeed, rather than critique these loans, too often loan purchasers reward unscrupulous lenders by paying more. This practice becomes problematic for assignees, however, as borrowers eventually succumb to pressures inherent in an abusive loan and foreclosures and value-reducing, unexpected prepayments resulting from refinancing grow. Evidence abounds that the market has been caught unaware in recent years by these trends, most notably in the large foreclosures that drove Conseco and other subprime lenders into bankruptcy.[35]

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independent verification. The CRC study examines data from a period ending June 30, 2000, the day before most of the North Carolina law's provisions took effect. Moreover, the data omits all open-end home loans from those lenders. Finally, the CRC study ignores the problem of "flipping" (refinancing loans with no benefit to the borrowers) and "steering" (providing subprime loans to prime-eligible borrowers) and consequently assumes that any reduction in subprime originations is evidence of harm. However, any successful anti-predatory lending law would curb both practices and thus would tend to reduce the number of subprime refinance originations.

[33] Borrowers seeking a remedy find that brokers typically have substantially fewer assets than lenders (one recent study put the average size of brokerages at ten employees) and are more likely to go out of business and be judgment-proof. *See* Wholesale Access, "New Research About Mortgage Brokers Published," (August 6, 2003) (available at: http://www.wholesaleaccess.com/8.6.03.mb.shtml) and Eggert, Kurt, "Held Up in Due Course: Predatory Lending , Securitization, and the Holder in Due Course Doctrine," Creighton Law Review, v35, n3 (April 2002), 507-640.

[34] *See* http://www.wholesaleaccess.com.

[35] Berenson, Alex, "A Boom Built Upons Sand, Gone Bust", N.Y. Times at B-1 (November 25, 2001); *See also*, Smith, Joseph A., "The Federal Banking Agencies Guidance on Subprime Lending: Regulation with a Divided Mind", North Carolina Banking Institute, v6, 73, 100 (2002) (discussing over-valuation resulting from gain-on-sale accounting related to securitization).

A. Investors have continued to do business under assignee liability rules in other contexts.

Hardly a new development, assignee liability exists in several other contexts related to lending. Since 1976, under the Federal Trade Commission Act, there has been assignee liability for many home improvement and mobile home mortgages that are nevertheless regularly securitized. The federal Truth in Lending Act likewise provides for limited assignee liability outside of HOEPA. Car loans also widely carry assignee liability into the securitization market under many state retail installment sales laws.

Even standard commercial law, enacted in virtually every state through the Uniform Commercial Code, provides for some degree of assignee liability. For instance, an assignee may not be considered a holder-in-due-course (and thus be entitled to enforce a promissory note without regard to a consumer's claim) if the assignee purchased a delinquent loan.[36] Furthermore, even a holder-in-due-course is subject to certain claims, including defenses based on duress, lack of legal capacity, illegality of the transaction, or fraud."[37]

HOEPA itself provides for assignee liability in two instances. First, in instances where a homeowner did not receive the material disclosures required by HOEPA, the homeowner may rescind the loan (tender the principal owed on the loan and receive in return all interest and fees paid on the loan), even after it has been assigned.

Second, and more relevant to the issue at hand, HOEPA provides that assignees of HOEPA high-cost home loans are subject to "... all claims and defenses ... that the consumer could assert against the original creditor...."[38] In instances where assignees are held liable pursuant to this provision, damages are capped at "the greater of (1) the applicable TILA damages or (2) elimination of the loan and recovery of all payment made."[39] In other words, without time limits apart from those governing the underlying cause of action, an assignee may be liable for damages equal to amounts owed plus all amounts paid on the loan, including amounts paid before it took assignment of the loan. The only exception to this strict liability lies in instances where an "assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence, could not determine ... [that the loan was a HOEPA high-cost home loan]."[40]

HOEPA's legislative history provides the following helpful explanation of the motivation for and desired effect of this provision:

> By imposing assignee liability, the Committee seeks to ensure that the High Cost Mortgage market polices itself. Unscrupulous lenders were limited in the past by their own capital resources. Today, however, with loans sold on a regular basis,

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[36] *See e.g.,* NCGS 25-3-302 (detailing this and other prerequisites to holder-in-due-course status).
[37] *See e.g.,* NCGS 25-3-305(a)(1).
[38] 15 U.S.C. 1641(d).
[39] *See e.g.*, In re Murray, 239 B.R. 728, 733 (Bkrtcy. E.D. Pa. 1999) (applying damages cap from 15 U.S.C. 1641(d)(2) and 15 U.S.C. 1641(d)(3)).
[40] 15 U.S.C. 1641(d)(1).

> one unscrupulous player can create havoc in a community by selling loans as fast as they are originated. Providing assignee liability will halt the flow of capital to such lenders.[41]

As one would expect, when faced with potential liability, assignees have developed techniques that limit their exposure. For example, in virtually every sale, loan purchasers protect themselves through representations and warranties that require the seller of the loans to indemnify the purchaser for all liabilities arising from the loans. Investors also conduct due diligence, such as loan sampling, to verify the integrity of the loans they are buying. Moreover, individual investors in securities backed by subprime home loans retain confidence since they have no individual liability under any assignee liability schemes designed in the states since they are not "holders" or "assignees" of the loans and consequently may not be sued.

B. Assignee liability in state anti-predatory lending laws encourage due diligence and provide limited recourse for victims of abusive practices.

Building on HOEPA's initial statement of assignee liability for high-cost home loans, states such as North Carolina, New Jersey, New Mexico, New York, and Illinois have developed and begun to implement new provisions that (1) provide a clear incentive for the secondary market to conduct due diligence to prevent the purchase of high-cost home loans, (2) ensure that homeowners being foreclosed on or otherwise suffering harm arising from a predatory loan can defend their home, and (3) cap liability at the amount of the loan plus costs and prohibit class action lawsuits against good faith secondary market participants that unintentionally purchase a high-cost home loan.

As the states have sought to address predatory lending by building on HOEPA's substantive rights, they have also typically refined the concept of assignee liability in a two-step approach. First, a company that refuses to exercise due diligence to prevent the purchase of high-cost home loans is subject to all the liability of the original creditor to preserve the claims of homeowners who otherwise would be left defenseless when the original creditor has sold the loan and subsequently gone out of business.

Second, for companies that accidentally purchase a high-cost home loan after engaging in due diligence (a rare occurrence), homeowners are given the right to defend their home against foreclosure or continuing harm, subject to several restrictions. The New Jersey Home Ownership Security Act of 2002, as well as laws in New Mexico and Illinois, provide examples of this two-step framework.

C. Impact of assignee liability on the secondary market is negligible.

Under the New Jersey approach, the bottom-line exposure of assignees under the legislation is negligible. In fact, the following chart provides a rough but conservative estimate of total exposure to show that good-faith loan assignees should find their total exposure amounting to less than 0.0001% of total loan purchases (or 0.01 basis points).

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[41] S.Rep. No. 103-169, at 28 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1881, 1912.

Occurrence necessary for exposure	*Estimated Likelihood*
High-cost home loan is purchased despite due diligence procedures to avoid it.	1 in 1,000
Loan contains a violation of high-cost protections.	1 in 10
Borrower identifies violation, retains individual lawyer (no class action claims allowed), and successfully prosecutes claim.	1 in 10
Seller who made promises not to sell high-cost home loans is insolvent and therefore can't indemnify secondary market actor.	1 in 10
All four factors met (0.001*0.1*0.1*0.1)	1 in 1,000,000

On May 13, 2004, Standard & Poor's published an explanation of its expanded credit enhancement criteria for loans originated in states with anti-predatory lending laws that include assignee liability provisions. The S&P announcement will have very little, if any, effect on the overall secondary market for mortgage-backed securities. As intended by the state laws they address, the ratings agency's credit enhancement requirements apply almost exclusively to high-cost loans—a very small subset of subprime loans.

In fact, S&P observes that, "the additional credit enhancement requirement will be applied primarily to high-cost loans that have historically not been a large component of Standard & Poor's rated transactions." The credit enhancement requirement may well mean that lenders will be forced to hold high-cost loans in their portfolios. This should discourage lenders from making unnecessary high-cost loans while allowing those loans that truly merit high-cost pricing to be made by lenders with sufficient financial strength to stand behind their loans—exactly the outcome desired by those who have supported strong state anti-predatory lending laws.

This prediction has already been borne out in North Carolina, which incorporates assignee liability by making a violation of the anti-predatory lending law a violation of state usury law. North Carolina case law has held assignees liable for usury violations and yet, since passage of its anti-predatory lending law, North Carolina subprime home loans have continued to be widely available and sold on the secondary market.[42]

V. Federal preemption of state anti-predatory lending laws would be misguided, as any federal standards should supplement, not replace, existing state efforts.

While North Carolina was the first state in the nation to pass strong anti-predatory lending legislation, others have followed and identified appropriate solutions for their particular

[42] See, e.g., North Carolina Anti-Predatory Lending Law Reviewed by Standard & Poor's, February 13, 2004, *available at* http://www.securitization.net/pdf/sp/NCarolina-Anti-Predatory_19Feb04.pdf.

context.[43] States have served as "laboratories of democracy" with respect to predatory lending by helping to refine solutions for important issues. States that passed laws after North Carolina have developed new definitions of points and fees that expand on the North Carolina definition by including back-end payments to brokers for placing borrowers in loans with higher interest rates than those for which they qualify (yield spread premiums); expanded the scope of loans provided with new protections by ensuring that open-end loans, including home equity lines of credit, are covered (North Carolina later adopted this point); clarified available remedies with more explicit provisions; and taken other steps, such as imposing fiduciary duties on mortgage brokers. Each of these steps represent meaningful advances in the evolving debate over how best to solve the predatory lending problem.

The experiences in New Jersey, Georgia, and other states show that concerns about the operation of specific legislative provisions can readily be resolved at the state level. After rating agencies raised questions about the Georgia law, a resolution was quickly reached that capped the liability of loan purchasers (to the amount of the loan) and provided additional protections for loan purchasers who engaged in due diligence (by protecting them against class actions). Georgia eventually chose not to enact this provision, and instead adopted a provision that cut off almost all assignee liability, far more than the rating agencies require. In New Jersey, the Department of Banking and Insurance has taken the lead in addressing concerns with the Garden State's assignee liability provisions through regulatory guidance. New Mexico deleted a provision of its legislation in response to legitimate concerns raised about the application of a component of the law. The point is not that these states adopted the perfect solution for predatory lending, but rather that each proved capable of quickly adjusting its standard to market needs, and in doing so may help define which policies protect and which fail to protect homeowners and lenders alike.[44]

Federal preemption of state anti-predatory lending laws would be misguided—and harmful to homeowners. When the federal government first legislated against predatory home lending through the HOEPA floor, states were free to go further. This dynamic has served the nation well, allowing for a "cooperative federalism" in which state-developed solutions and federal regulatory efforts inform and support each other.

A. Federal agencies have learned from state-based efforts to address predatory lending.

In at least two cases, federal agencies have learned from and acted upon lessons developed at the state level. In adopting changes to their regulatory framework, the Federal Reserve Board and the Office of Thrift Supervision each exemplified the best ideals of federalism.

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[43] Perhaps the most notable states in this regard include New Mexico, New York, and New Jersey; however, Illinois, Massachusetts, California, South Carolina, Arkansas, and Georgia have all made contributions to the pioneering efforts of states to identify solutions that protect homeowners and promote a thriving market.

[44] For a discussion of preemption, see e.g., Michael Greve, Subprime, but not Half-Bad: Mortgage Regulation as a Case Study in Preemption, *FEDERALIST OUTLOOK,* October 6, 2003, *available at* http://www.aei.org/publications/pubID.19271,filter./pub_detail.asp.

The Federal Reserve Board took important action in 2001 when it moved to incorporate single premium credit insurance within the scope of charges evaluated as a point or fee under HOEPA. But, the Federal Reserve did not arrive at this conclusion in a vacuum. Indeed, the first jurisdiction to reach such a conclusion was the state of North Carolina, which adopted a similar provision in its 1999 law. Even as North Carolina reached the conclusion that such products were harming consumers, it recognized that legitimate forms of credit insurance, calculated and paid on a monthly basis, did not have harmful equity stripping effects and should not be subject to the same scrutiny. Following the law's effective date, Freddie Mac and Fannie Mae and then many lenders publicly disclaimed such products and the market appears to have successfully transitioned to the monthly product. Consequently, the Federal Reserve acted responsibly when it saw that similar benefits could be extended through the federal HOEPA floor to borrowers in all states.

Similarly, some 35 states currently have statutory provisions relating to prepayment penalties on home loans. Yet, federal law had been interpreted to preclude these states from enforcing those laws against state-chartered finance companies and mortgage brokers in adjustable rate mortgages (ARMs) and other alternative mortgage transactions. Increasingly, subprime prepayment penalties in home loans have come under scrutiny and a number of states have moved to prohibit them outright or to limit their application. In recognition of these developments, the Office of Thrift Supervision took commendable action when it revised federal regulations in a way that promoted cooperative federalism by restoring the states' rights to apply their laws to these state-chartered institutions.

B. States are best equipped to respond to abuses in their particular markets.

I urge you today to continue in this vein and partner with states to provide protections for the nation's homeowners. In addition to losing the opportunity for synergy with state efforts, federal preemption of state law is not a practical response to predatory lending because states are in the best position to respond to many of the challenges presented by predatory lending, for at least three reasons: (1) many of the bad actors involved in predatory lending are state-chartered entities with minimal capitalization, (2) regional variations in real estate markets require different solutions to predatory lending, and (3) irresponsible lenders can invent new abusive practices virtually overnight, and the federal government is ill-equipped to react quickly to these changes.

First, federal enforcement of financial services laws depends largely on periodic examinations of the practices of large institutions. The broker who just hung a shingle from his door, however, can originate abusive loans without much fear of federal oversight—as can a state-chartered affiliate of a bank that is not likely to affect its larger parent's overall safety and soundness. State attorneys general and bank regulators have been instrumental in investigating abusive practices and in demanding redress for their citizens. They are also the primary regulators of non-depository finance companies, which dominate the subprime market. The federal government simply cannot be everywhere at once to monitor local real estate transactions.

Second, predatory lending laws should address the special characteristics of each state's underlying real estate regime and market. For example, the mechanism for ensuring that a

borrower can raise defenses to foreclosure on predatory home loans may depend on whether a state has judicial or non-judicial foreclosure procedures. The appropriate loan-size threshold for when to prohibit prepayment penalties may depend on the real estate values in a given state. North Carolina prohibits prepayment penalties in first-lien home loans of less than $150,000. In California, the most reasonable threshold would perhaps be considerably higher.

Third, new financial services products are developed every day, frequently to exploit loopholes in laws against abuse. If HOEPA preempted state laws back in 1994, North Carolina never could have outlawed single premium credit insurance, and the abusive practice would still be widespread today. In North Carolina, the legislature prohibited the sale of financed credit insurance. Within two years, the similar "but-not-insurance" product of "debt cancellation agreements" was born, and many states have moved to cover such products as they address single premium credit insurance through legislation. State legislatures are better suited than Congress for responding quickly to such changes.

C. Lenders have experience complying with a variety of state laws that affect their business practices, and complying with state-based homeowner protection laws presents no heavier a burden.

Given the evidence of success at the state level, Congress would do harm to homeowners by imposing a uniform standard in lieu of state protections. Every day, lenders deal with tremendous variety in state real estate laws and practices, including consumer protection laws.[45] The laws concerning who may act as a settlement agent differ from state to state. Foreclosure law differs from state to state. States have their own fraud and deceptive practices acts, interpreted by state court judges in accordance with state-specific common law. Just as lenders find tools for complying with these and other variations, we believe that they are capable of complying with state-based homeowner protection statutes as well. The market has responded by producing computer products that claim to assist lenders in their compliance obligations across state borders.[46] In fact, the variation in these statutes is actually quite small, and we can expect states to move even closer to a consensus approach as regulation of predatory lending improves in its ability to curb abuses. With the incredible recent growth in subprime lending that has occurred, it is simply not credible to claim that variations in state laws have hamstrung this industry.

Conclusion

Both subprime lending and the securitization of subprime loans increased by over 50 percent in 2003 over 2002, and lenders continue to be optimistic about the growth of the subprime market. A recent news report on the Mortgage Bankers' Association Subprime Lending Conference found that industry predicted further growth in 2004. "The times have

[45] Significantly, federal laws such as the Fair Housing Act and the Equal Credit Opportunity Act regulate the real estate finance market without broadly preempting comparable state regulations.
[46] *See* Bergquist, Eric, "Some Lenders Turning to Compliance Software", American Banker, v168, n62 (April 1, 2003).

never been better for subprime," stated David Farrell, a senior vice president at Countrywide Financial Corp., West Hills, Calif., and chairman of the MBA's Nonconforming Credit Lending Committee. "I don't see much beyond blue skies ahead," he said, noting that Countrywide alone did $3 billion in alternative loans in April.[47]

Unfortunately, borrowers continue to face the danger of abusive lending practices that threaten to strip their hard-earned equity. States have been at the forefront of fighting these abuses, both through the important efforts of state officials and through legislation that provides meaningful protections that deter lenders from even making predatory loans. I encourage you to look carefully at the success of the state efforts and urge you to support the important work that has already been done to preserve the wealth of American families.

[47] Lew Sichelman, National Mortgage News, "Line Between Prime and Nonprime Gets Blurry," May 24, 2004.

APPENDIX A

"Flipping" Prohibitions in N.C. Elicit No Substantial Litigation

Center for Responsible Lending
May 7, 2004

Background
Responding to widespread instances of predatory lending in the late 1990s, North Carolina enacted landmark anti-predatory lending legislation. As part of that law, policymakers included a prohibition against loan flipping—an abuse that occurs when lenders make loans primarily for the purpose of generating additional fee income without providing borrowers with any offsetting benefit. For a borrower to prevail under the North Carolina standard, he or she must show that the refinancing of a home loan provided no "reasonable, tangible net benefit" in light of "all of the circumstances" and that the lender "knowingly or intentionally" made the offending loan.[48]

This standard provides incentives for lenders to reduce the incidence of flipping by more closely monitoring the underwriting and origination of refinance. At the same time, potential litigants are discouraged because of the standard's scienter requirement. In addition, a requirement that the trier of fact to specifically review "all of circumstances", including "the borrower's circumstances", makes it impossible for a claim to be asserted on behalf of a class of borrowers, each of whom would have differing circumstances.

Identification of Likely Defendants
While it is not possible to measure directly the incidence of flipping, it is possible to analyze whether borrowers are pursuing flipping claims in any substantial numbers. To do so, one must identify a set of potential defendants. Since predatory lending practices, including loan flipping, most commonly occur in the subprime sector, our analysis focused on that sector. We identified the nation's top 10 subprime lenders based on total origination volume over the five-year period since the North Carolina law became effective (1999-2004). These lenders, identified in Figure 1, were responsible for an estimated 58.5% of all subprime originations since the North Carolina flipping standard became effective.

[48] The standard is codified in North Carolina General Statutes, Chapter 24, Section 10.2.

Figure 1: Top 10 U.S. Subprime Home Lenders (10/1999-12/2003)

Lender	***Volume (millions)***
Citifinancial / Associates	$81,647
Household / Beneficial	$79,063
Ameriquest Mortgage	$61,844
Washington Mutual / Long Beach	$57,006
New Century Financial	$53,070
Option One Mortgage	$48,427
Countrywide Financial	$41,949
First Franklin Financial	$41,525
Homecomings (GMAC-RFC)	$36,258
Wells Fargo Home Mortgage	$26,865
A. Total of Top 10	$527,654
Total Estimated Subprime Home Loans	$901,950
Share of Top 10	58.5%

Sources: *The 2004 Mortgage Market Statistical Annual, The 2003 Mortgage Market Statistical Annual.*

Identification of Relevant Lawsuits

Next, we used fee-based electronic services (Westlaw, Pacer) supplemented by a direct review of courthouse records by attorneys to measure the extent to which the top subprime lenders had been sued in North Carolina during the relevant period. While a large percentage of cases we identified were in North Carolina District Court, where damages are limited to $10,000, rather than state Superior Court, we nonetheless chose to examine cases from both courts to ensure maximum inclusion. In addition, borrowers could conceivably bring actions in federal court or adversary proceedings in bankruptcy court based on a flipping claim. Our analysis focused on court data that includes each of these possibilities.

We first found the total number of lawsuits filed against the identified lenders in state and federal court. Of these, we eliminated those cases where records clearly indicated that the subject matter could not involve a flipping claim. For example, some records indicated that the claim was employment-related. Others involved lawsuits brought by plaintiffs ineligible to assert a flipping claim, such as commercial entities. We identified 41 lawsuits in state court and 27 lawsuits in federal court (see Figure 2) where one might find an allegation of flipping. These data tend to over-count the possibility of a flipping claim since they may include claims based on non-home loans and, even in the class of home loans, loans made for purchase that by definition could not support a claim of improper refinancing.

Figure 2: Total NC State Court and Federal District Court Litigation Against Top 10 Subprime Lenders (10/1999-5/2004)

Year	*Lawsuits with Possible Flipping Allegations*	*Lawsuits Reviewed*	*Flipping Claims*
1999	0	0	0
2000	4	2	0
2001	20	15	0
2002	17	17	0
2003	22	21	0
2004	5	5	0
Total	68	60	0

Sources: *Westlaw, Pacer.*

While the data in Figure 2 reflect every suit filed against the identified lenders in North Carolina in federal district court, due to limitations in the Westlaw source, it represents cases filed in state court only in the counties of Mecklenburg, Guilford, Forsyth, Wake, Buncombe, Cumberland, and Durham. However, we believe these seven counties provide more than an adequate basis for assessing the incidence of potentially relevant litigation in North Carolina state courts generally since, according to an analysis of Loan Performance Inc.'s ABS database, they accounted for 48.4% of all subprime originations in the state during 2003.

Results of State Lawsuit Review

Once the total relevant state lawsuits were identified, we directly reviewed all of the complaints filed in those lawsuits in Guilford, Durham, and Wake counties to estimate the incidence of flipping allegations. These counties were chosen because they had the largest number of relevant filings (93% of the identified lawsuits were in those counties). Using Loan Performance Inc.'s ABS database once again, we calculate that these counties alone accounted for 20.7% of North Carolina's 2003 subprime market production. In our review of the 38 lawsuits filed in these state courts, we found no allegations of flipping.

Results of Federal District Lawsuit Review

To evaluate possible litigation claims in Federal District Court in North Carolina, we reviewed complaints available on the Internet through Pacer. Of the 27 federal lawsuits identified as potentially containing an allegation of flipping, 22 complaints (81%) were manually reviewed.[49] We identified no allegations of flipping in any of the federal district court cases.

Results of Bankruptcy Review

Finally, we evaluated whether borrowers were bringing flipping claims in the context of a bankruptcy proceeding. To do so, we used Pacer to access U.S. Bankruptcy Court filings from 1999 to present in both the Middle District and the Western Districts of North Carolina, while filings for the Eastern District were not available. In each instance, we identified the number of bankruptcy claims in which a borrower named one of the top 10 subprime lenders as a creditor, which occurred 12,941 times. We then pulled a random sample of 126 files for further review to determine whether the borrower had challenged the validity of the debt and/or sought discharge

[49] In the remaining 5 instances the complaints were not electronically available.

of the lien securing the debt in an adversary proceeding in the bankruptcy context while alleging flipping. Within our sample of filings in U.S. Bankruptcy Courts in North Carolina, we identified no instances of flipping allegations.[50]

Figure 3: Debtors Listing Top 10 Subprime Lenders as Creditors in U.S. Bankruptcy Court – Middle and Western District (1999 to present)

Lender	*Bankruptcy Filings*	*Files Reviewed*	*Flipping Claims*
Citifinancial / Associates	3,116	29	0
Household / Beneficial	1,858	19	0
Ameriquest Mortgage	226	4	0
Washington Mutual / Long Beach	2,579	25	0
New Century Financial	42	1	0
Option One Mortgage	449	8	0
Countrywide Financial	1,791	15	0
First Franklin Financial	0	0	0
Homecomings (GMAC-RFC)	586	15	0
Wells Fargo Home Mortgage	2,294	10	0
Total	12,941	126	0

Source: *Pacer*

Conclusion

A review of relevant filings in North Carolina District and Superior Courts, Federal District Courts, and U.S. Bankruptcy Courts identified no instances in which a borrower has alleged flipping since the North Carolina anti-predatory lending law became effective. Given the scope of the review performed we believe this to be compelling evidence that exceedingly few, if any, flipping claims are being alleged against subprime lenders.

[50] Since zero instances of flipping were identified, the sample error is not readily calculated. However, had one instance of flipping been identified in the 126 files reviewed (0.79%), the sample error would have been 1.5% at a 95% confidence level. Accordingly, even if we had found one flipping claim, we would be confident in predicting that fewer than 2.3% of debtors filing in these courts would allege flipping in the course of a bankruptcy proceeding.

The Nonprime Mortgage Market in the United States

By

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Before the
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and Subcommittee on Housing and Community Opportunity,
of the Committee on Financial Services
The U.S. House of Representatives

June 23, 2004

Introduction

One of the most important changes in the mortgage lending industry over the last thirty years was the decoupling of loan origination from loan financing. This separation of loan origination from financing of the loan was made possible by the development of a securitization market for mortgage loans. The mortgage backed securities market was developed by the so-called government-sponsored enterprises (GSEs), which are the Federal National Mortgage Association, better known as Fannie Mae, and the Federal Home Loan Mortgage Corporation, better known as Freddie Mac and by the Government National Mortgage Association, or Ginnie Mae. Loan originators no longer need to hold a mortgage loan until maturity or sell whole loans to other financial institutions. With the development of the mortgage securities markets, lenders can sell entire pools of loans not just to other banks and thrifts, but to a diverse set of investors such as pension funds, mutual funds, life insurance companies or individuals. By bringing new investors to the market, securitization has dramatically increased funding for housing finance, lowered costs and increased access to credit across the country. The decoupling of loan origination from financing has lead to a "mortgage market that is mammoth in size."[i] Today, the size of the mortgage securities market exceeds the size of the corporate bond market.[ii] The decoupling of loan origination from loan financing has created a more efficient market with lower costs, lower margins and lower interest rates.

During the 1990s, the percent of American households that own their homes rose to 68%.[iii] Investors that finance mortgage loans include major financial institutions (often different from the originator), federal and related agencies, mortgage pools or trust and individuals. The broad funding support for mortgage loans goes well beyond the originator of the mortgage loan. To be most efficient, investors that are the source of funding for mortgage debt desire reliable risk analysis of the potential borrower, good reputations of all involved in the mortgage lending process, transparency of the process and standardization of the process, and clarity in the laws governing both.

Nonprime Mortgage Market

The nonprime (also called subprime) mortgage market has expanded rapidly over the last few years. Researchers at the Federal Reserve found that "Home-purchase lending to lower-income and minority households and to residents of lower-income and minority neighborhoods has expanded significantly in recent years and at a faster rate than lending to other borrowers."[iv] A U.S. Department of Housing and Urban Development (HUD) report documents the growth in nonprime lending and attributes this growth to a number of factors: "federal legislation preempting state restrictions on allowable rates and loan features, the Tax Reform Act of 1986, increased demand for and availability of consumer debt, and an increase in subprime securitization."[v]

When I first researched the nonprime mortgage market in 1998, there wasn't a precise definition for the characteristics of a nonprime borrower in the literature.[vi] Often, lenders were using slightly different standards. Today, there is a very active mortgage-backed securities market for nonprime loans, which has been enabled by greater standardization. Nonprime origination and financing has been decoupled, just as it has for the prime mortgage market. The nonprime mortgage market has expanded rapidly over the last five years. The origination of nonprime mortgages in 2003 was estimated at $325 billion, and is estimated to represent 10.5% of all mortgage originations.[vii]

There are a lot of similarities to the growth in the nonprime mortgage market and the corporate bond market that developed in the eighties for companies with a bond rating below BBB. Prior to the development of a bond market for these companies, many of them were unable to get funds for needed capital spending. Many of these companies, that at the time were young start-ups that hadn't established a bond rating, went on to become very successful companies and have contributed greatly to the economic growth in the U.S. over the last twenty-years. Prior to the development of the high-yield market in the eighties many start-ups and other companies without well-established credit records could not borrow to expand. The high-yield bond market grew dramatically because of the growth of a secondary market for securities from companies with less than a BBB bond rating. And the growth in lending to these companies led to another source of economic growth in the U.S. during the late eighties and nineties.

Following a parallel growth pattern to corporate bonds, the nonprime bond market has grown dramatically as bond financing for mortgages has expanded. This expansion came

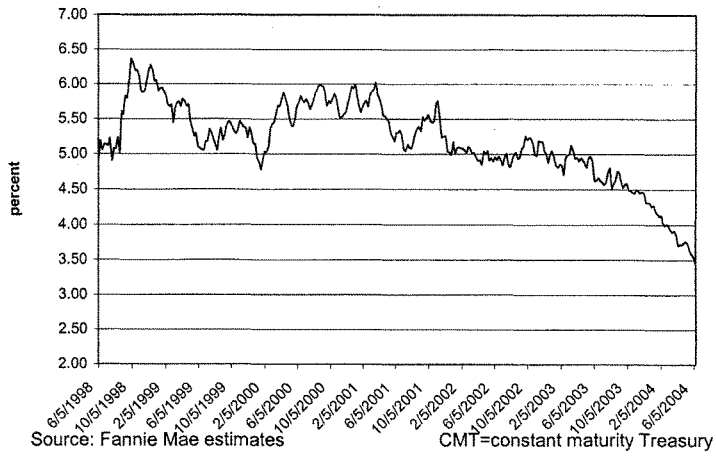
about as more institutions and other investors became willing to invest in mortgage-backed securities that included nonprime mortgage securitizations. The fixed income bond became the predominant provider of capital to the nonprime mortgage borrowers community in the late eighties.[viii] Fixed income bond investors replaced portfolio lenders like banks and thrifts as the primary source of funds for nonprime loans. It is estimated that two-thirds of nonprime mortgage loans are now securitized in the secondary market.[ix]

This expanding source of funds meant that many individuals with less than perfect credit records were able for the first time to buy a new home, refinance their current home loan, remodel or expand their current home, or borrow for many other productive reasons such as financing theirs, or their children's, college education. Prior to the development of the nonprime mortgage lending industry and its secondary market, many well deserving potential borrowers with a less than perfect record could not borrow. Now however, with the vast expansion of the nonprime mortgage credit, these deserving potential borrowers are able to participate in the American Dream of home ownership. I am sure that making this credit available to those without a perfect credit record has contributed to, just as lending to companies with less than a BBB bond rate in the eighties contributed to, economic growth in the U.S. as these nonprime borrowers were able to buy their first home or remodel and expand their current home or invest in their own, or their children's education, or start their own business with the capital that was provided by the nonprime loans.

Spreads

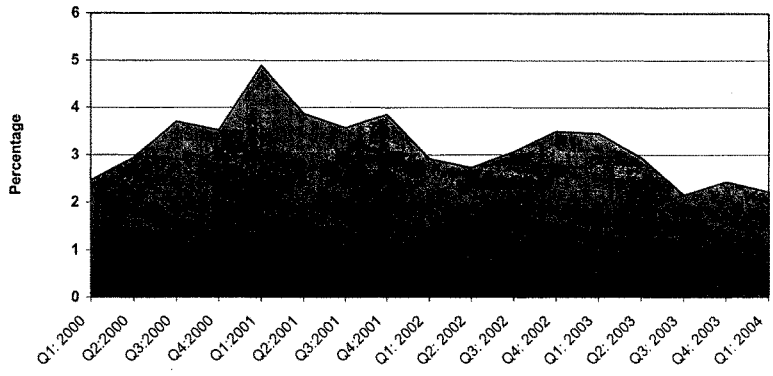
Just as high-yield interest rate spreads dropped in the eighties after the development of an active secondary market, so have nonprime interest rate spreads dropped over the last six years, especially during the last two years. Exhibit 1 shows the interest rate spreads between nonprime loans and the ten-year constant maturity Treasury (CMT) rate over the last six years. Exhibit 2 uses national data on a quarterly basis. Notice the drop in spreads over the last two years in both Exhibits. As economic theory suggests, interest rate margins for the lenders have decreased with the growing competitiveness in the markets. These decreased interest rate spreads are good news for nonprime borrowers because they represent lower interest rates to the nonprime borrower.

Exhibit 1
Subprime Spread Over 10yr CMT



Source: Fannie Mae estimates CMT=constant maturity Treasury

Exhibit 2
Difference in "B" Credit and 30 yr FHA-Insured FRM



Source: *B&C Market at a Glance* (various issues) FRM=fixed rate mortgages

Disruptions to the Nonprime Mortgage Market

Financial markets crave certainty and similarity. Often commentators will talk about the stock market dropping because of uncertainty. The same is true in the nonprime mortgage market. A law that isn't clear, or certain, may cause the liquidity of a nonprime market to drop dramatically as lenders and investors move to more certain investments, and thus drive up interest rates in the nonprime market to compensate for the uncertainty caused by the law. Investors are typically risk averse. They demand a higher return for increased risks. An investor will avoid uncompensated risk no matter if it comes from the vagueness of the law or some other market disruption. Illiquidity in financial markets is caused by the fact that investors have many choices for investments. So if an investment becomes uncertain or riskier, investors will fund other more certain and less risky investments. This will cause a disruption in the availability of financing for nonprime mortgage lending.

An example of this type of disruption was the New Jersey Home Ownership and Security Act of 2002. (This law is currently being amended). When studying this law's impacts, I found that from the first two months after its implementation as compared to the two months prior to its implementation, nonprime lending in New Jersey dropped by more than two-thirds. When I compared the drop in New Jersey to the seasonal drop in Pennsylvania for the same time periods, I found that the drop in New Jersey significantly higher than the small seasonal drop in Pennsylvania. The drop in New Jersey that seemed to be primarily due to the change in the law was approximately 60 percent.[x] Other examples of state laws that, at least, initially disrupted the markets were the anti-predatory laws in Georgia and New Mexico. There are two things to keep in mind when looking a different state or cities laws that affect nonprime mortgages. The first impact to look at is to determine what the state allows or doesn't allow and the second impact to look at is how much more difficult national lending processes and standards become with different laws in various jurisdictions. The "federal legislation preempting state restrictions on allowable rates and loan features" was the first factor that accounted for the growth in nonprime lending in the nineties that was listed in a HUD report.[xi] Any vagueness in the law will only further disrupt funding sources, as investors will be very reluctant to invest in a nonprime mortgage when there is some uncertainty about the law. Another factor of some state laws that may cause investors to avoid funding nonprime mortgages are severe penalties. Even if the law is reasonably clear, investors will invest in other markets where the penalties for an unintentional error are not as severe.

The liquidity of the nonprime mortgage market, as is true in other fixed income markets, depends upon the willingness of investors to invest. To a large extent investor willingness to invest in a financial instrument depends on the investors' confidence in the given market. Thus, investors are dependent upon the good reputation of the mortgage originator and everyone involved in the mortgage origination transaction and the securitization process. The major rating agencies, Moody's and Standard & Poor's, play an integral role in building the confidence of investors in a fixed income security. The liquidity of a market drops substantially when a rating agency is unable to reliably rate a pool of mortgages from a certain jurisdiction, as the state or municipality's anti-predatory

laws make it difficult to assess credit risks of the mortgage pools. As Joanne W. Rose, Executive Managing Director of Global Structured Finance at Standard & Poor's, stated so well, that "If we can't quantify the risk, we can't rate the structure."[xii] Investors count on these credit ratings and will probably not add liquidity to mortgage debt markets if the instruments are not rated by these well-respected agencies.

A quilt pattern of state and city laws will further hinder nonprime markets by complicating lenders' and investors' ability to set up automated funding flows. Standardizing pools of nonprime mortgages enables lenders to set up automated funding processes which lower the costs of lending and thus should lead to lower interest rates for nonprime borrowers. However many of the state and city laws require nonprime lenders to set special programs for each jurisdiction, which in turn increase their costs and thus the interest rates to nonprime borrowers.

In an op-ed piece in *The New York Times,* Mr. Robert E. Litan of the Brooking Institute and Professor Charles W. Calomiris at Columbia University stated: "New laws on the pattern of some already passed at the state and local level could do great harm by discouraging lenders from making any subprime loans at all. Laws that effectively limit fees and interest in mortgage contracts are tantamount to usury ceilings, which have generally been eliminated for a good reason: They force lenders to ration credit and thus deny funds to some borrowers."[xiii]

Any disruption in the mortgage market will cause ripple effects. A drop in credit availability, for whatever reason, will not only deprive deserving borrowers credit, but will have an effect on the overall economy since these borrowers will not be able to borrow to buy a new home, remodel or expand their current homes. This reduction of credit will then have consequences for many trade workers (carpenters, electricians, plumbers, painters and other trades) who could have been hired by the borrowers to build new homes or remodel or expand their current homes. In addition, the nonprime borrower won't have the same opportunity as prime borrowers to refinance their homes at lower interest rates or use the borrowed funds for higher education expenses. This only reinforces their economic hardships and hinders any hope for progress beyond current social standings.

Well-Crafted Federal Law

A well-crafted federal law that could prevent undesirable lending practices, while at the same time preventing disruptions to nonprime lending in local markets is needed. By well crafted, I am describing a law that sets clear and objective standards to prevent certain undesirable actions like predatory lending. This well-crafted federal law should also help avoid disparity in local laws on nonprime borrowing, illiquidity in the nonprime mortgage lending market, and disruptions to automated funding flows.

National Markets

Just as is true with the prime mortgage market, the nonprime mortgage market has become national as the large institutional lenders have replaced banks and small finance companies as the primary source of funds. The nonprime mortgage market has significantly consolidated over the last ten years. The top ten nonprime lenders now represent over 65 percent of the nonprime market, according to *Inside B&C Lending*.[xiv] These lenders make nonprime loans on a national basis and their funding comes from investors from all over the United States and abroad. In contrast to the regional differences that were found in mortgage interest rates when I first got into banking in the mid-1960's, today there are almost no regional differences in mortgage interest rates. Not only are there almost no regional differences in mortgage interest rates, there are very little differences in the interest rates from one lender to another.

In my mind, the law regulating a national market should be federal. Having one national standard would enable the market to grow while at the same time preventing abusive lending practices. HUD listed four factors accounting for the growth in the nonprime markets in the 1990s and the very first reason listed was "federal legislation preempting state restrictions on allowable rates and loan features."[xv] To continue this growth of nonprime lending and allow those with less than perfect credit records to share in the American dream of home ownership, I urge Congress to enact a federal law aimed at eliminating abusive lending practices that provides clear and objective standards and that applies to all lenders.

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[i] Anthony M. Santomero and David F. Babbel, *Financial Markets, Instruments, and Institutions*, 2nd Ed., McGraw-Hill Irwin, 2001, p.277

[ii] ibid., p. 277

[iii] "Recent Changes to a Measure of US Household Debt Service," *Federal Reserve Bulletin*, October 2003, p. 421

[iv] "The Role of Special Lenders in Extending Mortgage Credit to Low-Income and Minority Homebuyers," *Federal Reserve Bulletin*, November 1999, p. 709

[v] "Subprime Markets, the Role of GSEs, and Risk-Based Pricing," U.S. Department of Housing and Urban Development, March, 2002, p. vii

[vi] Richard F. DeMong, "Subprime (B&C Credit) Mortgage Loans, *Equity*, Fall 1999, pp. 7-9

[vii] SMR Research, "Subprime Mortgage Loans, 2004"

[viii] "Analysis of The Impact of Prepayment Penalties on Residential Subprime Lending Coupons," Pentalpha Group LLC, May 12, 2004, p.3

[ix] "Statement of The Coalition for Fair and Affordable Lending ("CFAL") and New Century Financial Corporation On 'Subprime Lending: Defining the Market and Its Customers,'" Joint Hearing of the Subcommittee on Housing and Community Opportunity and Subcommittee on Financial Institutions and Consumer Credit, US House of Representatives, March 30, 2004

[x] Richard F. DeMong, "The Impact of the New Jersey Home Ownership Security Act of 2002, NHEMA (http://www.nhema.org/press.asp?bid=596), March 2004

[xi] "Subprime Markets, the Role of GSEs, and Risk-Based Pricing," U.S. Department of Housing and Urban Development, March, 2002, p. vii
[xii] S&P Correct: S&P Report Addresses New Jersey State Predatory Lending Laws
[xiii] Robert E. Litan and Charles W. Calomiris, *The New York Times*, August 20, 2001
[xiv] "Top 25 B&C Lenders in 2003," *Inside B&C Lending*, February 9, 2004, p. 2
[xv] "Subprime Markets, the Role of GSEs, and Risk-Based Pricing," U.S. Department of Housing and Urban Development, March, 2002, p. vii

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President, The Bond Market Association

Testimony before
U.S. House of Representatives
Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Housing and Community Opportunity

Hearing on Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market
June 23, 2004

Thank you Chairmen Bachus and Ney along with Ranking Members Sanders and Waters for holding this important hearing on the need for liquidity in the market for subprime mortgage loans. We also thank other members of the full Committee who have been helpful in advancing the discussion of the policy challenges facing subprime lending.

Home mortgage credit for subprime borrowers—the segment of mortgage customers with less-than-perfect credit—is more widely available at a lower cost today than ever before, in part because securitization provides a more liquid market for these loans. Securitization and the secondary market efficiently link the mortgage and capital markets, providing more credit at a lower price than would otherwise be available. As a result, more subprime borrowers are able to obtain mortgage financing and purchase homes than would otherwise be the case.

Home mortgage credit for subprime borrowers—the segment of mortgage customers with less-than-perfect credit—is more widely available today at a lower cost in part because securitization provides a more liquid market for these loans. Securitization and the secondary market efficiently links the mortgage and capital markets, providing more credit at a lower price than would otherwise be available. As a result, more subprime borrowers are able to obtain mortgage financing and purchase homes than would otherwise be the case.

Unfortunately, the subprime sector of the consumer credit market is also the most likely to attract predatory lenders. With the Homeownership and Equity Protection Act (HOEPA) in 1994, Congress restricted certain lending practices for high-cost loans in an effort to protect the most vulnerable subprime borrowers. The law built on the legal notion of "assignee liability" or the potential that liability for lending violations could be assigned to a loan purchaser. In their own efforts to combat predatory lending, state and local governments have passed new laws that move beyond HOEPA's assignee liability provision. The result is a patchwork of laws in a cross-section of jurisdictions that sometimes use vague and conflicting standards to make secondary market participants liable for lending violations. When applied this

way, assignee liability provisions have caused some loan purchasers to curtail and—in some instances—stop securitizing loans made in certain jurisdictions. The situation threatens to drive up the cost and limit the availability of credit for subprime borrowers.

Securitization and the Secondary Market for Mortgage Loans

Mortgage securitization involves the transformation of mortgage loans into mortgage-backed securities (MBS) that are issued and traded in the capital markets. The principal and interest payments on mortgages are pooled and passed through as payments to bondholders. The financial institution that originated the loan can put its proceeds from selling the loan back to work in the form of a new mortgage. This process accelerates the flow of mortgage funding and results in lower cost and more widely available credit for borrowers.

Loan purchasers must take steps to understand the quality of the pools of loans acquired to issue MBS. MBS issuers need to assure investors the loans in a pool will perform—or that borrowers will make timely mortgage payments—in order to achieve the best pricing in the capital markets. Loans made under predatory terms are often more likely to default than other loans which is further motivation for loan purchasers to eliminate bad loans from the pools they acquire.

The review of loan pools, which is also called due diligence, actually occurs at two levels—the loan supplier and with the loan itself. With the loan supplier, among the issues considered are any lending abuse-related litigation and the supplier's lending record. Loan purchasers are careful to establish they are doing business with a reputable supplier. Screening individual loans involves a review of the documentation of the mortgages for indications the loan was extended under prohibited terms. Loan purchasers also look for conformity with underwriting guidelines and the integrity of the loan data.

Typically, loan purchasers will review a sample of the mortgages for compliance with applicable laws. The entire review process relies on representations and warranties the loan originator makes regarding the accuracy of loan pool documentation. Not having taken part in the lending process, the loan purchaser cannot know if a high-cost loan originator acted in a way that violates an anti-predatory lending law unless the results of that action can be objectively recorded in the loan file. The interest rate a loan carries, for example, is easy to detect from the loan file. Whether or not the lender misrepresented an important loan term, on the other hand, will not be reflected in the loan documentation.

Regulatory Approaches to Curbing Predatory Lending

HOEPA has been the primary regulatory weapon against predatory lending since its enactment in 1994. The law created the concept of a "high-cost" loan as one with an annual percentage rate or fees that exceed a threshold. The Federal Reserve Board has the authority to adjust the threshold which is presently set at 8 percentage points over the yield on a Treasury security of comparable maturity. Alternatively, loans

that carry points or fees the greater of $499 or 8 percent of the loan amount qualify as high-cost under HOEPA. The Fed also writes the regulation guiding the law's implementation.

In recent years, several states and localities have built on HOEPA's fundamental approach with new anti-predatory lending laws to the point that up to 70 percent of the subprime market could now be affected. Of the more than 40 varying state and local anti-predatory lending laws, many employ a lower threshold than HOEPA. Loans that fall into the high-cost category are subject to certain restrictions. Terms deemed to have the potential to be predatory are prohibited.

Many of the laws use subjective triggers to assign liability to the loan purchasers. In some cases, this subjectivity creates legal circumstances inconsistent with the notion of fundamental fairness. A loan purchaser should not face liability for lender actions it did not observe and that cannot be detected in the loan file.

Using anything but a single set of objective and readily detectable standards to determine whether an assignee has liability is a regulatory approach that threatens to undermine many of the benefits of the secondary market. Faced with this type of environment, secondary market participants may find it less attractive to purchase and repackage subprime loans.

The Association believes the current regulatory environment negates many of the efficiencies securitization and the secondary market bring to the subprime mortgage market. Anti-predatory lending laws that assign liability to the secondary market for lending violations that cannot be detected in a review of the loan documents will ultimately limit subprime borrowers' access to credit.

The Association supports a single federal standard and is ready to work with Congress in crafting a federal anti-predatory lending law that uses clear and objective standards to address the harmful lending abuses that occur in the subprime mortgage market. The new law should assign liability to the secondary market only for those lending violations that can be detected in a review of regular loan documentation.

The Need for Clarity and Objectivity

Association members believe Congress should draft legislation that would not violate the fundamental notion of fairness with respect to the secondary market by assigning liability to loan purchasers for lender behavior that was not witnessed and cannot be detected in the loan file. There are many current examples of state and local anti-predatory lending laws that contain ambiguous definitions of lending violations for which a loan purchaser could be liable. It is the Association's view that some of these provisions can be successfully clarified. Some jurisdictions, however, have enacted laws containing requirements that cannot be met under any circumstances.

Set out below are examples—taken from existing state and local laws—of provisions that fall into three categories: "clear and objective", "objective but not clear" and "not objective."

1. Clear and Objective

- **Negative Amortization**

> *"No high-cost home loan may contain a payment schedule with regular periodic payments that cause the principal balance to increase."* (North Carolina, New York State)

2. Objective, but not Clear

- **Repayment Ability**

A borrower's ability to repay a loan is a key element of the underwriting decision. A lack of documentation of repayment ability could indicate a loan originator's primary objective is to establish a right to the borrower's house, a predatory practice known as wealth stripping. No responsible lender would operate this way and no loan purchaser would want to take possession of such a problem mortgage. Loan purchasers and reputable lenders will favor provisions in anti-predatory lending legislation requiring documentation of ability to pay for high-cost loans, if they include a clear metric for determining when a borrower is considered able to pay. The following is an example of statutory language taken from a Florida law that fails to provide such a yardstick.

> *"(6) Extending Credit Without Regard to the Payment Ability of the Borrower. –A lender making a high-cost home loan shall not engage in any pattern or practice of extending high-cost home loans to borrowers based upon the borrowers' collateral without regard to the borrowers' ability to repay the loan, including the borrowers' current and expected income, current obligations, and employment."* (Florida)

Effectively, this law only requires a lender to consider income, other debts and employment when making the determination whether or not to extend credit. It does not indicate at what point a lender could be found in violation of this provision—only that ability to repay must be considered. The statute also fails to succinctly identify what sources the lender should use in making a determination. By contrast, language such as the following passage clearly describes ability to pay and names the documents that should be used to reach this conclusion.

> *"...The borrower shall be so determined if, at the time the loan is consummated, said borrower's total monthly debts, including amounts under the loan, do not exceed 55% of said borrower's monthly gross income as verified by one or more of the following: tax returns, payroll receipts, and other third-party income verification."*

3. Not Objective

- **Deceptive practices**

Many of the concerns raised by secondary market participants over predatory lending legislation have focused on provisions that are not only vague but also impossible to comply with because loan purchasers cannot detect the prohibited activity through a review of the loan file. Efforts to effectively ban what are considered deceptive practices, for example, are hampered by their inherent subjective nature. It is not possible for loan purchasers to determine whether a lender acted in a fraudulent or deceptive manner based on a review of the loan file. The following examples from Illinois and Michigan of legislative efforts to ban deceptive practices illustrate the challenge in drafting an objective standard.

> *"Section 25. Good faith dealings; fraudulent or deceptive practices. A lender must act in good faith in all relations with a borrower, including but not limited to, transferring, dealing in, offering, or making a high-risk home loan.*
>
> *No lender shall employ fraudulent or deceptive acts or practices in the making of a high-risk home loan, including deceptive marketing and sales efforts."* (Illinois)

> *"(5) A statement or representation is deceptive or misleading if it has the capacity to deceive or mislead a borrower or potential borrower. The commissioner shall consider any of the following factors in deciding whether a statement or misrepresentation is deceptive or misleading:*
> *(a) The overall impression that the statement or representation reasonably creates.*
> *(b) The particular type of audience to which the statement is directed.*
> (c) *Whether it may be reasonably comprehended by the segment of the public to which the statement is directed."* (Michigan)

Both examples ask the loan purchasers to make determinations that are not possible based on the information provided in the loan file. There is no way—using either routine or extraordinary due diligence—to know whether a lender acted in good faith and avoided deceptive or misleading statements. Loan purchasers cannot comply with the above provisions of the Michigan and Illinois laws. Moreover, it is unlikely any statutory language could be crafted to create an objective test to determine whether a lender had engaged in a deceptive practice.

Conclusion

The Bond Market Association looks forward to working with Congress as lawmakers set out to meet the policy challenge of preserving access to mortgage credit while

providing prudent safeguards against subprime mortgage lending abuses. It is critical, however, that efforts to eliminate the bad element of the subprime mortgage market—predatory lending—do not limit the ability of the secondary market to lower the cost of mortgages while making them more broadly available. The current disparate patchwork of vague and sometimes conflicting state and local laws threatens to do just that. We hope these subcommittees continue to work on a national anti-predatory lending standard that preserves access to subprime mortgage credit and does not assign liability to the secondary market for the actions of lenders that market participants did not observe and cannot detect from the loan file. The Bond Market Association stands ready to assist in this process in any way possible.

Endnotes

TESTIMONY OF ASSISTANT ATTORNEY GENERAL PAMELA KOGUT
OFFICE OF MASSACHUSETTS ATTORNEY GENERAL THOMAS F. REILLY

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
AND SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

Joint Hearing on June 23, 2004

Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market

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Chairman Ney, Chairman Bachus, Ranking Member Sanders, Ranking Member Waters, and Members of the Subcommittees:

Introduction and Background:

I appreciate the opportunity to present the views of Massachusetts Attorney General Tom Reilly's Office concerning the subprime mortgage market. As you gather information about how state laws and law enforcement actions may affect the subprime mortgage market, I can offer the perspective of a law enforcement office with a long history of bringing cases against mortgage lenders that have engaged in unlawful practices, including cases against subprime mortgage lenders. I will highlight a recent case we brought against First Alliance Mortgage Company.

The experiences of the Massachusetts Attorney General's Office will lend some perspective to the questions you pose concerning whether state law enforcement actions affect the flow of liquidity in the subprime mortgage and lending markets. Our state laws and law enforcement efforts have not resulted in any reluctance on the part of mortgage lenders to do business within the Commonwealth. In fact, according to our Division of Banks, the mortgage lending business has grown in Massachusetts.[1]

Enforcement Action by the Massachusetts Attorney General Against First Alliance Mortgage Company:

First Alliance Mortgage Company, an Irvine, California based mortgage lender, obtained a license to make mortgage loans in Massachusetts from the Massachusetts Division of Banks in

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[1] For instance, according to the Massachusetts Division of Banks, there were 297 licensed mortgage lenders in the Commonwealth for the year 1999, compared with 417 for the year 2004. The Division licenses both mortgage lenders and mortgage brokers, and reports that there has been a steady increase in the numbers of licensed mortgage lenders and brokers since 1999, the last year for which total numbers are readily available. In 1999, there was a combined total of licensed mortgage brokers and lenders of 627, in 2000 there were 698, in 2001 there were 754, in 2002 there were 837, in 2003 there were 953, and in 2004 there were 1,082.

March of 1997. The Division of Banks conducted a routine inspection of FAMCO's books and records approximately one year later, and during this examination found that FAMCO was regularly charging Massachusetts borrowers more than twenty points for their mortgage loans. Concerned with these extremely high points charges, the Division of Banks issued an examination report to FAMCO on May 7, 1998 which took note of the points problem, and referred the matter to the Massachusetts Attorney General's Office for enforcement.

The Massachusetts Attorney General's Office brought suit against FAMCO on October 30, 1998 in Suffolk County (Boston) Superior Court. The main allegation in the Commonwealth's complaint was that FAMCO had violated a regulation of the Massachusetts Consumer Protection Act by providing a mortgage loan with "terms which significantly deviate from industry-wide standards or which are otherwise unconscionable."[2] The complaint alleged other general violations of the Massachusetts Consumer Protection Act, but the lawsuit was intended to focus cleanly and swiftly on the points charges, which were clearly unconscionable by Massachusetts standards.[3]

The FAMCO case proceeded along a normal litigation path after we filed the civil complaint: we sought and obtained a preliminary injunction in the case in November of 1998 which limited FAMCO to charging no more than five (5) points on new loans made (and which resulted in FAMCO ceasing to do business in Massachusetts[4]), we sought and obtained discovery including all of the loan files of the Massachusetts borrowers, and we served a motion for summary judgment on February 15, 2000.

FAMCO only did business for about one year in the Commonwealth -- and made only 299 mortgage loans to Massachusetts residents. But the damage done to our consumers was significant: we calculated that from the 299 loans made, Massachusetts consumers paid FAMCO more than three million dollars in points charges alone.

On March 23, 2000, a year and a half after the Commonwealth instituted its action against FAMCO and before our civil suit was resolved, FAMCO filed for bankruptcy protection in the

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[2] 940 Code of Massachusetts Regulations, Section 8.06(6).

[3] The industry-wide standard for points charges in the Commonwealth among non-bank mortgage lenders providing loans to consumers whose credit ranged from A to C, during the period that FAMCO made mortgage loans here (between March 1997 and November 1998), was a range of from zero to four.

[4] During the hearing on the Commonwealth's application for a preliminary injunction, FAMCO informed the state court that it would not be able to afford to continue to do business in Massachusetts if it were to be limited to charging consumers only five points. After the court issued its order, FAMCO closed its Massachusetts branch office, and ceased making loans in Massachusetts.

Central District of California.

That bankruptcy action was not resolved until March 21, 2002, and at the end of the day, Massachusetts consumers saw only cents on the dollar in terms of their actual recovery.

During the course of the litigation, here is what we learned about FAMCO's practices in Massachusetts:

a) Of the 299 loans that FAMCO made to Massachusetts borrowers, 35.57% contained points charges in excess of 20 (in two cases, borrowers paid more than 30 points); 73.15% contained points charges in excess of 10; 96.64% contained points charges in excess of five; and only 3.36% contained points charges that were less than five.

b) Although FAMCO characterized itself as a "subprime lender," of the 299 loans made in Massachusetts, 20% were made to borrowers who were rated A or A-, according to FAMCO's standards. There appeared to be no correlation between the points charged and credit scores.[5] The Massachusetts FAMCO borrowers were middle-class and did not necessarily meet the traditional definition of "unsophisticated" consumer. Most were long-standing homeowners in their communities, whose equity in their homes represented their largest asset.[6]

c) 187 of the 300 FAMCO loans (that is, more than half of the loans) had adjustable rates of interest (as opposed to fixed rates). Regardless of market conditions, these interest rates were set up so that they would never decrease. Instead, the interest rates, and the consumers' monthly mortgage payments, increased every six months. To calculate the increases, FAMCO used a LIBOR index plus a large margin. (The margin most often used was 7.99.) This presented significant confusion for many borrowers who did not understand that the initial rate of interest was a teaser rate. Many consumers believed that when prime rates decreased, their interest rates (and monthly mortgage payments) would correspondingly decrease, and were surprised to learn that this was not the case.

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[5] According to the loan files, FAMCO made mortgage loans to the following numbers of consumers in the following credit-rating categories: A or A-: 59; B or B-: 115; C or C-: 115; and D: 8.

[6] One FAMCO borrower, for example, was a single woman, aged 61. She borrowed the total sum of $47,257, to be paid back in 30 years. She had an adjustable rate note that had an initial interest of 9.49%. The consumer paid more than 25 points, or $11,098.77, in points. FAMCO had designated this woman an "A" rated borrower -- that is, a consumer whose credit history and debt-to-income ratio would have qualified her for a conventional, conforming mortgage loan with competitive rates and costs. She was a middle-class borrower from a good neighborhood near Boston.

d) Twenty-eight Massachusetts borrowers had their loans "flipped." That is, FAMCO refinanced its own mortgage loans shortly after the original loans were consummated. Most of these borrowers paid the same level of points again, and again these points were financed. For example, one couple in their 60s paid $15,757 in points the first time (or 20.96 points), and when they refinanced with FAMCO just 14 months later, paid $15,778.61 (or 15.32 points) the second time. 23 of the 28 loans were flipped within one year of the first loan.

e) FAMCO telemarketers were taught to urge consumers to get new FAMCO loans at every opportunity. If consumers called for a loan payoff figure, telemarketers were instructed to sell a new loan. If consumers were late making one payment, FAMCO telemarketers were instructed to call consumers to urge them to refinance.

f) The Massachusetts consumers did not seek out FAMCO. They were solicited. The solicitations were misleading, and included, for example, the suggestion that the loans contained no closing costs, even though most consumers paid enormous points charges.

g) FAMCO trained its loan originators to memorize and follow a deceptive sales pitch called the "Loan Officer Track."[7] The "Track" instructed loan officers to confuse and lie to consumers. For instance, loan officers were trained to tell consumers that if consumers made monthly mortgage payments that were larger than those they were required to make, consumers would pay off their loans early and at a significant savings. The loan officers were directed to refer to this section of the "Track" in response to possible questions about the substantial points charges, and to suggest that the points charges, which were set forth on written disclosure statements as required by law, merely represented a worst case scenario. But this representation was false: every FAMCO consumer paid the points in full on the day the loan closed.[8] Further, when consumers make larger monthly payments than those required by their mortgages and notes, they will save money over the life of the loan on *interest* payments, but this strategy will not affect *points* charges, which are static and are paid at the inception of the loan.

FAMCO's lending practices became well known. Before the bankruptcy action was completed,

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[7] The loan originators FAMCO sought to hire were not employees who had demonstrated experience in the mortgage lending business but instead were car salespeople with an established record in car sales. It was not insignificant that their training consisted solely in getting them to memorize the "Track" rather than in instructing them on mortgage lending laws.

[8] The FAMCO consumers financed their points payments; the points charges were added onto the principal amount of the loan. This meant that consumers paid interest on the points charges, and it also meant that consumers were more easily duped – consumers were simply not alerted to the large points payments they were making since FAMCO lied about the charges, and since they were not asked to write a check to cover the points costs.

FAMCO was sued, in addition to the first suit filed by the Massachusetts Attorney General, by the Attorneys General of Minnesota, Illinois, Florida, California, and Arizona, the New York State Banking Department, the Federal Trade Commission, AARP, and private counsel in individual and class actions. Within the bankruptcy case, all of the plaintiffs worked cooperatively, focused on the common aspects of the laws in our states and in the FTC Act, and coordinated our efforts. Ultimately, FAMCO, Brian Chisick, the person primarily responsible for the business, and Sarah Chisick, his wife, were together ordered to provide restitution to approximately 18,000 borrowers nationally. The Chisicks were ordered to contribute the sum of $20 million towards consumer redress, and FAMCO was ordered to liquidate its business.

To date, the redress fund has collected approximately $85 million, including tens of millions of dollars from FAMCO's liquidated assets and the $20 million from the Chisicks, and approximately $63 million of that fund have been distributed to consumers. Although this was an extremely significant dollar settlement against a predatory lender, especially the contributions the Chisicks made to the settlement, it still was not enough to make consumers whole. Ultimately, Massachusetts consumers received only cents on the dollar, as was the case for consumers nationally.

The coordinated plaintiffs made a very important decision to bring an action against Lehman Brothers, the investment firm that had securitized FAMCO's loans. Because Lehman Brothers' involvement came after FAMCO ceased doing business in Massachusetts, our office was not actively involved in the litigation against Lehman Brothers, but the suit resulted in a tremendous victory: the jury found that FAMCO systematically defrauded borrowers, and that Lehman Brothers aided and abetted in the fraudulent scheme by continuing to securitize loans even after it became plain that FAMCO was engaging in unscrupulous practices. The jury found that the total damages to consumers nationally was about $51 million. The jury was asked to determine the extent of Lehman Brothers' responsibility, and concluded that Lehman Brothers was liable for 10% of the consumers' harm (while finding that FAMCO was 90% liable). Thus, Lehman Brothers was ordered to pay the sum of approximately $5.1 million. Because this decision is currently on appeal, Lehman Brothers has not yet paid on this judgment. If the jury's verdict is upheld, consumers may see another distribution.

Lessons Learned from the FAMCO Case:

The most difficult aspect of the FAMCO case was that even after learning all we did about this lender's bad practices, we were unable to make consumers whole. The bankruptcy case was completed, the redress funds were delivered, but our consumers did not receive full restitution. Ultimately, the losses to each Massachusetts consumer were substantial.

At the time when we began our suit against FAMCO, Massachusetts did not have a law making the assignees of the FAMCO loans specifically liable for FAMCO's conduct, and we did not sue any party other than FAMCO in our state litigation. The FAMCO case made painfully clear to us the extent to which consumers can be harmed by an unscrupulous lender, even when there are

reasonably good consumer protection laws on the books. We realized that FAMCO was able to accomplish a fair amount of harm in Massachusetts, and a large amount of harm nationally, because of its access to the secondary market, and in part for this reason we would look closely at the possibility of naming secondary market defendants in the future.

Were we to file a case in Massachusetts state court today against a predatory lender such as FAMCO, we would likely sue assignees in order to ensure that any money judgment obtained would be satisfied. We would be able to do so because the Massachusetts Commissioner of Banks adopted "high cost" loan regulations, which became effective on March 22, 2001, and which contain assignee liability provisions.[9] In addition, there is a bill currently pending in the Massachusetts legislature to enact a law to make assignees liable for the acts of their assignor mortgage lenders, again in the context of "high cost" loans. These regulations (and prosepective law) give us important tools to get full relief for our consumers.

We also note the important function that assignee liability may play within the mortgage lending system. Secondary market entities such as Lehman Brothers have strong and ready tools available to perform due diligence of a lender such as FAMCO. It is likely that, had Lehman Brothers exercised even minimal due diligence in reviewing FAMCO's lending practices, and had it known it would be held liable for serious deficiencies, it would not have provided a lifeline to FAMCO by way of securitizing its loans. Had the sources of funding from the secondary market not been available to FAMCO, it would presumably have ceased operating, and victimizing consumers, much earlier.

Given FAMCO's plainly egregious conduct, it was important for the multiple plaintiffs in the FAMCO case to bring suit against Lehman Brothers, and to establish that a company such as Lehman Brothers which had knowledge (and which could fairly easily have learned yet more) about FAMCO's tactics cannot escape liability. This is important from a law enforcement perspective: all of the participants in the making of consumer mortgage loans should be held accountable for the making of unlawful mortgage loans. If they are not, then what we will see at the end of the day is that families – the least sophisticated among all of the players – will be left holding the bag, and the bag will be empty.

Other Law Enforcement Actions By the Massachusetts Attorney General Against Subprime Mortgage Lenders:

In addition to the case against FAMCO, the Massachusetts Attorney General brought an action in 1996 against United Companies Lending Corporation ("UCLC"), a Louisiana based mortgage lender that charged consumers 10 points, plus sizeable mortgage broker fees which were not disclosed as required by Massachusetts law, among other unlawful practices. UCLC also filed for bankruptcy protection, but the Commonwealth obtained a final judgment, including restitution payments to consumers in the approximate total sum of $860,000, just before the

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[9] 209 CMR 32.32.

bankruptcy action was filed.

In 2002, our Office and 18 other state Attorneys General and financial regulators settled claims against Household Finance and its Beneficial Finance unit, a settlement every state in the country eventually joined. We alleged that Household had engaged in a number of shady mortgage lending practices, including luring consumers by way of deceptive "live checks," flipping loans, and engaging in bait and switch tactics that left consumers with two loans at closing rather than one, and aggregate loan amounts at more than 100% of the value of the home. Our settlement contained injunctive relief which changed the way the company does business, and consumers across the country shared in a $484 million redress fund.

Conclusion:

The Commonwealth of Massachusetts has strong and reasonable consumer protection laws on the books, and the Massachusetts Attorney General has used these laws to bring cases against subprime lenders that have engaged in unlawful practices. These laws and our enforcement efforts have not stopped mortgage lenders from doing business in the Commonwealth.

The Commonwealth needs to be in a position to adjust and strengthen its consumer protection lending laws to the unscrupulous practices which develop here. As a state law enforcement office, we want to be in the position of being able to file the strongest possible lawsuits to protect our residents when unscrupulous lenders attempt to steal our residents' hard-earned home equity.

TESTIMONY OF FRANK RAITER
MANAGING DIRECTOR
STANDARD & POOR'S CREDIT MARKET SERVICES

SUBMITTED TO THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY
And
THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

U.S. HOUSE OF REPRESENTATIVES

HEARING ON: PROMOTING HOMEOWNERSHIP BY ENSURING LIQUIDITY IN THE SUBPRIME MORTGAGE MARKET

JUNE 23, 2004

Standard & Poor's Ratings Services ("Standard & Poor's"), part of Standard & Poor's, a division of The McGraw-Hill Companies, Inc. ("McGraw-Hill"), appreciates the opportunity to share its views on its approach to rating securities backed by loans governed by anti-predatory lending statutes. As an independent and objective commentator on credit risk, Standard & Poor's generally does not take a position on questions of public policy. Thus, while Standard & Poor's strongly supports efforts to combat predatory lending and other abusive practices by lenders, it does not take a position on what legislative and regulatory actions would best accomplish that goal. Nevertheless, Standard & Poor's has been closely following legislative and regulatory initiatives designed to combat predatory lending in order to determine how those laws might affect its ability to rate securities backed by residential mortgage loans. Accordingly, Standard & Poor's is pleased to discuss the factors that it considers when evaluating the impact of anti-predatory lending laws on its rated transactions, and, in particular, the issue of assignee liability.

INTRODUCTION

Since beginning its credit rating activities in 1916, Standard & Poor's has rated hundreds of thousands of securities issues, corporate and governmental issuers and structured financings. Standard & Poor's began its ratings activities with the issuance of credit ratings on corporate and governmental debt issues. Responding to market developments and needs, Standard & Poor's also assesses the credit quality of, and assigns credit ratings to, financial guarantees, bank loans, private placements, mortgage- and asset-backed securities, mutual funds and the ability of insurance companies to pay claims, and assigns market risk ratings to managed funds.

Today, Standard & Poor's has credit ratings outstanding on approximately 150,000 securities issues of obligors in more than 50 countries. Standard & Poor's rates and monitors developments pertaining to these securities and obligors from operations in 20 countries around the world. With a U.S. staff of approximately 1,250 Standard & Poor's rates more than 99.2% of the debt obligations and preferred stock issues publicly traded in the United States. [Check #s]

Standard & Poor's believes that over the last century credit ratings have served the U.S. securities markets extremely well, providing an effective and objective tool in the market's evaluation and assessment of credit risk. Standard & Poor's recognizes the valuable role that credit rating agencies play in the U.S. securities markets and is committed to protecting and enhancing the reputation and future of its credit ratings business. In this regard, Standard & Poor's takes great care to assure that its credit ratings are viewed by the market as highly credible and relevant and will continue to review its practices, policies and procedures on an ongoing basis and modify or enhance them, as necessary, to ensure that integrity, independence, objectivity, transparency, credibility, and quality continue as fundamental premises of its operations.

When Standard & Poor's issues a rating, it is offering its opinion about a company's medium to long-term credit risk. Similarly, ratings on particular instruments, such as the securities related to structured finance transactions, reflect Standard & Poor's opinion about the likelihood of default on those securities. In determining all of its ratings, Standard & Poor's tries to take into account whatever relevant future events may be anticipated.

Standard & Poor's does not perform an audit of the issuer, does not guaranty an issuer's payment on its debt, or provide insurance in case the issuer does not pay the debt. A Standard & Poor's rating does not constitute a recommendation to purchase, sell, or hold a particular security. Nor does a Standard & Poor's rating speak to the suitability of an investment for particular investors. Rather, a rating reflects Standard & Poor's opinion as of a specific date of the creditworthiness of a particular company or security based on Standard & Poor's objective and independent analysis.

EVALUATING ANTI-PREDATORY LENDING LAWS

General

Increased access to mortgage loans has led to increased home ownership across the U.S. While this growth in home ownership is positive, it has become evident that some of this increase has unfortunately occurred simultaneously with a rise in predatory lending practices. Among others, these predatory practices include the following: charging excessive interest or fees; making a loan to a borrower that is beyond the borrower's financial ability to repay; charging excessive prepayment penalties; encouraging a borrower to refinance a loan notwithstanding the lack of benefit to the borrower; and increasing interest rates upon default.

To protect borrowers from unfair, abusive, and deceptive lending practices, numerous state and local governmental bodies have enacted anti-predatory lending laws. Typical laws include provisions that:

- Limit the interest rates and fees that a lender may charge;
- Preclude lending to borrowers without regard to their ability to repay;
- Require refinance loans to provide a net tangible financial benefit to the borrower;
- Prohibit excessive prepayment penalties and balloon payments;
- Require disclosure to the borrower of various loan provisions; and
- Require counseling for borrowers who are planning to take out certain loans that are governed by these laws.

Anti-predatory lending laws are designed to protect borrowers from such practices, and Standard & Poor's strongly supports efforts to combat predatory lending. For several reasons, however, these laws may also have the negative effect of reducing the availability of funds to such borrowers. First, a lender might reduce its lending in a given jurisdiction to protect itself from being found in violation of the jurisdiction's anti-predatory lending law. Second, a lender might reduce its business because the cost of lending in accordance with a law's provisions might be uneconomical. Third, a lender might reduce its activities within a given jurisdiction if the market for the sale of loans originated in that jurisdiction is effectively eliminated. This would occur, for example, if an anti-predatory lending law imposes liability on purchasers or assignees of loans causing potential purchasers and assignees to reduce, or even cease, their purchasing to avoid liability under the law.

Moreover, and most importantly from Standard & Poor's perspective, an anti-predatory lending law's imposition of liability on purchasers or assignees of mortgage loans ("assignee liability") might reduce the availability of funds to pay investors in securities backed by mortgage loans governed by the law. This would occur if the purchaser or assignee were found to hold a loan that violated the law ("predatory loan"), even if the purchaser or assignee did not itself engage in predatory lending practices. Therefore, in performing a credit analysis of structured transactions backed by residential mortgage loans, Standard & Poor's evaluates the impact an anti-predatory lending law might have on the availability of funds to pay investors in the rated securities. To the extent that Standard & Poor's determines that investors in securities backed by loans governed by an anti-predatory lending law might be negatively impacted, Standard & Poor's may require additional credit support to protect investors or, in certain circumstances, preclude such loans from being included in Standard & Poor's rated transactions.

Evaluation of Laws

In performing its evaluation of anti-predatory lending laws, Standard & Poor's considers, among other factors, whether the law provides for the following: (i) assignee liability; (ii) clearly delineated loan categories; (iii) penalties, including monetary damages, as well as restrictions or prohibitions on doing business with the governmental entity whose legislation is at issue; and (iv) clarity of statutory violations and safe harbors.

1. *Assignee Liability*. As the first part of its analysis, Standard & Poor's will review an anti-predatory lending law to see if it imposes assignee liability in connection with any type of loan covered by the law (a loan with associated assignee liability is referred to in this discussion as an "exposed loan"). Standard & Poor's defines assignee liability as liability that attaches to a purchaser or assignee of a loan (including a securitization trust) simply by virtue of holding a predatory loan. An anti-predatory lending law may impose assignee liability in a direct action by the borrower or only defensively, i.e., in an action by the purchaser/assignee to enforce a loan. Typically, laws that impose assignee liability permit a borrower to assert the same defenses against the purchaser or assignee as it could assert against the original lender.

If Standard & Poor's determines that no assignee liability is provided for under the law, Standard & Poor's will, generally, permit loans covered by the law to be included in Standard & Poor's rated transactions. If, on the other hand, Standard & Poor's determines that a given jurisdiction's anti-predatory lending law does permit assignee liability, Standard & Poor's will continue with the second part of its analysis.

2. *Statutory Loan Categories*. As the second part of its analysis, Standard & Poor's examines the categories of loans that are identified in the law. Standard & Poor's considers whether the language of the law clearly distinguishes between those loans that are covered by the law and those that are not, as well as among the various loan categories (for example, covered, high cost) covered by the law. Standard & Poor's looks to see if a loan originator, a seller of loans into a securitization transaction, or a purchaser or assignee of loans would be able to determine what category of loan (according to the law the entity is originating, selling, or purchasing.

If Standard & Poor's concludes that the distinctions discussed above are not clearly set forth in the law, then Standard & Poor's may not be able to rate transactions that include any loans originated in the relevant jurisdiction.

If, however, Standard & Poor's determines that the distinctions discussed above are clearly set forth in the law, Standard & Poor's will determine for which loan categories the law provides assignee liability. In general, and consistent with its approach discussed above in section 1, Standard & Poor's will permit loans with no associated assignee liability to be included in its rated transactions. In connection with exposed loans, Standard & Poor's will continue with the third part of its analysis.

3. *Penalties*. For exposed loans, Standard & Poor's will consider whether the law exposes the assignee or purchaser to monetary damages and, if so, whether such monetary damages are limited to a determinable dollar amount (i.e., the damages are capped). Standard & Poor's will perform this analysis for all types of monetary damages that may be assessed under the law, including statutory, actual, and punitive damages, as well as any other type of monetary damages provided for in the law.

If the damages for violation of a law in connection with a given loan category are not capped, Standard & Poor's will not be able to size the potential liability into its credit

analysis and thus will not, as a general matter, permit these loans to be included in Standard & Poor's rated transactions.

If, on the other hand, Standard & Poor's determines that, for any given loan category, the monetary damages are capped, as a general matter, Standard & Poor's will be able to size in its credit analysis the potential monetary impact of violating the law and will continue with the fourth part of its analysis. In this regard, it should be noted that the ability of Standard & Poor's to size capped damages in its credit analysis is distinct from the question as to whether it would make economic sense to securitize loans, especially if the credit enhancement required equals or exceeds the monetary value of the loan. For example, some laws provide for rescission or voidance of a predatory loan and require that all amounts paid, including principal and interest, be returned to the borrower. Other laws permit a borrower to continue to hold a predatory loan, but forgive all interest that otherwise would be due. In addition, if a law provides for punitive damages (even if these damages are capped), the amount of the damages may well exceed the loan value. In some of these instances, securitization of these loans may prove to be too costly.

If an anti-predatory lending law imposes nonmonetary penalties on purchasers or assignees, e.g., restrictions or prohibitions on doing business with the governmental entity whose legislation is at issue, Standard & Poor's will review these penalties to determine the effect, if any, that these penalties will have on securitization transactions.

4. *Clarity of Statutory Violations; Safe Harbors*. As the fourth part of its analysis, Standard & Poor's will look to see how clearly an anti-predatory lending law sets forth what constitutes prohibited actions and/or omissions for each exposed loan category. Standard & Poor's looks for clear language that would enable an originator, seller, or assignee of an exposed loan to comply with the law. In addition, Standard & Poor's will look to see if the lawsets forth certain methods (for example, due diligence procedures and policies against the purchase of certain loans covered by the law) that a purchaser or assignee can implement to avoid liability ("safe harbors").

Evaluation of Seller's Compliance Procedures and Creditworthiness

In addition to reviewing an anti-predatory lending law for the factors discussed above, Standard & Poor's will also review the compliance procedures of any entity that proposes to sell mortgage loans into a securitization ("seller"). In this regard, Standard & Poor's will review a seller's compliance procedures, to determine if they are effective to identify (a) exposed loans, i.e., those subject to assignee liability, and (b) predatory loans, i.e., those that are in violation of the law. These factors assume increased significance in transactions where the seller proposes to include exposed loans. As mentioned above, in some instances, Standard & Poor's will require additional credit enhancement for inclusion of certain exposed loans.

Based upon its evaluation of all of the factors discussed above, as well as any other factors Standard & Poor's deems pertinent, Standard & Poor's will determine if any of the

loans covered by an anti-predatory lending law may be included in its rated transactions, and what, if any, additional credit enhancement may be required.

CONCLUSION

In summary, in its evaluation of the credit risk to investors of rated securities backed by mortgage loans governed by anti-predatory lending laws, Standard & Poor's looks for statutory language that clearly sets forth what constitutes a violation under such a law, which parties may be liable under the law, the extent of such liability (monetary and otherwise), and whether any monetary liability is limited to a determinable dollar amount. Absent clarity on these issues, in order to best protect investors in rated securities, Standard & Poor's adopts a conservative interpretation of an anti-predatory lending law, and may, in instances in which liability is unlimited, exclude mortgage loans governed by a given anti-predatory lending law from transactions that it rates.

In offering these written comments, Standard & Poor's reiterates to the Honorable Members of the Subcommittee on Housing and Community Opportunity that, as a public policy matter, it is in favor of legislation that attempts to curb predatory and abusive lending practices. Standard & Poor's also acknowledges, however, that its role is to evaluate the credit risk to investors associated with anti-predatory lending legislation and not to recommend public policy, the making of which is the responsibility of elected officials.

Statement of the Coalition for Fair and Affordable Lending (CFAL)
On
"Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market"
Before the
Subcommittees on Housing and Community Opportunity & Financial Institutions and Consumer Credit
Of the
Committee on Financial Services
U.S. House of Representatives

June 23, 2004

The Coalition for Fair and Affordable Lending ("CFAL") appreciates the opportunity to submit this statement concerning the importance of ensuring liquidity in the nonprime mortgage market.[1]

First, we want to commend Chairman Ney and Chairman Bachus for their continued leadership in scheduling today's hearing so Committee Members can hear suggestions from interested parties on how Congress can best preserve market liquidity while also preventing abusive lending practices and preserving access for all Americans to affordable mortgage credit.

For the reasons discussed below, we recommend that the following four features, among others, be incorporated in federal legislation embodying uniform nonprime lending standards to promote efficient capital markets and liquidity:

- ✓ **Provide lenders/purchasers with clear definitions of what is required** *(e.g., qualifying any anti-flipping loan benefit test with a "knowing or intentional" requirement and adding specific "safe harbors" indicating types of loans that are deemed to provide the required benefit)*;
- ✓ **Mandate lenders/purchasers have a meaningful opportunity to correct errors** *(e.g., 90 days after closing + 90 days after discovery, with the lender in such after discovery cases being required to make full restitution and to pay the borrower a reasonable error penalty and reasonable attorney's fees if the error discovery is made by the borrower or a regulator)*;
- ✓ **Impose reasonable penalties that are proportional to the nature of the violation**; and

[1] The Coalition for Fair and Affordable Lending (CFAL), launched January of 2003, was formed to advocate national, uniform fair legislative standards for nonprime mortgage lending. CFAL's members make around one-third of all nonprime mortgage loans and sell into, or securitize in, the secondary market many billions of dollars in nonprime loans every month.

- ✓ **Require only limited assignee liability** *(e.g., assignees should only be held liable for violations that they know or could know based on their following reasonable industry practices for due diligence that ensure they are not purchasing loans containing statutory violations; damages for assignees should be expressly capped/limited; class actions should not be allowed; and safe harbors should be provided so that assignees can have greater certainty that no violations have occurred).*

Nonprime lending fills a vital niche in our nationwide mortgage market, with roughly 10% of the loans being made to borrowers who cannot qualify for the lowest available rate, so-called conventional or "prime" mortgages. Nonprime lending promotes homeownership for millions of families who otherwise could not qualify for a mortgage at prime rates in at least two important ways: (1) many nonprime lenders make 20%-30% or more of their loans for home purchases; and (2) they make loans to refinance homeowners' existing mortgages and allow many to utilize some of their equity to meet financial challenges or opportunities without having to sell their homes. But, the availability and affordability of these nonprime loans is highly dependent on maintaining liquidity in this market segment. Lenders must be able to sell nonprime loans they originate into the secondary market so they can obtain new capital which can then be used to make new nonprime loans, thereby increasing credit availability for borrowers who can not qualify for prime rate mortgages.

Liquidity can be seriously curtailed by overly restrictive legislation, especially if assignees of nonprime loans have broad liability for any violation made by loan originators before the assignees purchased the loans. Therefore, it is critically important that Congress address this assignee liability question with a good understanding of the issues involved and with the knowledge that legislation must limit such liability, as we note subsequently.

Uniform National Standards Are Needed

As CFAL representatives have stated in prior testimony, some lenders, brokers, and others involved in the mortgage origination process engage in inappropriate lending practices that need to be stopped.[2] Many of these abuses are fraudulent, deceptive, and already illegal.[3] However, CFAL feels that new federal statutory requirements also are needed to remove gaps or to correct weaknesses in current law. We believe that these new provisions, including new requirements for limited assignee liability, should replace the current patchwork of differing state and local "anti-predatory lending" laws and be applied on a uniform, nationwide basis to provide effective, fair and workable protections

[2] See statements on behalf of CFAL at the Subcommittees' hearings on November 5, 2003 by Steve Nadon and on March 30, 2004 by Terry Theologides.
[3] Enhanced enforcement together with more consumer financial education and counseling opportunities also are needed to help prevent them.

for all borrowers.[4] And, we want to see both federal and state regulators actively enforce these nationwide standards.

Nonprime Lending Depends On Continued Capital Liquidity

As Committee members know, housing is critically important to our nation. Not only is homeownership "the American Dream," and central to the welfare and stability of families and communities, it is vital for our nation's economy. Housing has been an essential economic engine for us. Millions of Americans rely on nonprime lenders and their home equity to help meet their credit needs and this is especially important during tighter economic times. We clearly need to ensure that they are not abused in the mortgage lending process, but we also must make certain that "protective" measures do not harm them by limiting their access to needed credit or unnecessarily increasing its cost.

Today's nonprime mortgage industry has truly become an interstate business that is increasingly dominated by large nationwide lenders. The primary reason that this business has grown dramatically in the last decade and has been able to provide credit at relatively low rates to millions of Americans who could not have qualified for conventional financing is the development of a strong secondary market for nonprime loans. Our industry has become much more automated, standardized, and efficient, and now securitizes most of the loans we originate. Roughly two-thirds of the $325 billion in nonprime mortgages originated last year were securitized. Securitization has let lenders bring in vast amounts of capital from the national and global markets. This has both enabled us to make far more credit available and to dramatically decrease the rates we charge borrowers.[5] However, overreaching, unclear or conflicting legislation, regardless of how well-intended it is, can easily disrupt the capital markets on which this industry depends for funds to make most of its loans to borrowers, and thus have a serious adverse impact on both credit availability and borrowers' credit costs.

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[4] Uniform standards are needed because the arbitrary and irrational growing patchwork of state and local laws intended to prevent mortgage lending abuses is proving to be unduly burdensome and costly. Many borrowers are not receiving adequate statutory protections. Moreover, federally chartered depositories, as well as some state chartered entities, are being exempted from these state and local laws' requirements. This creates not only an unlevel regulatory playing field for lenders, and, thus, is anti-competitive, but it also increases confusion and inconsistent levels of protection for borrowers. Many consumers are not being adequately or equally protected by these measures. These consequences of a confusing, inconsistent, and arcane patchwork of local and state laws threaten disruption to and impairment of the efficient and effective functioning of the national housing finance market.

[5] The securitization process is described in a recent GAO report, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending* (January 2004). See selected excerpts in the attached Appendix "A".

Assignee Liability And Poorly Crafted Statutory Requirements Limit Liquidity

Experience under various differing state and local "anti-predatory lending" laws (e.g.; Georgia; New Jersey; New Mexico) has shown that liquidity is curtailed as the capital markets react to poorly crafted and onerous requirements. Common elements in unworkable statutes include:

1. Unclear requirements which make compliance very difficult and sometimes impossible (e.g., an unqualified, undefined "tangible net benefit" requirement);
2. Limited opportunities to correct mistakes;
3. Severe penalties;
4. Class action liability; and
5. Broad assignee liability.

Not surprisingly, some states' statutes have been so poorly crafted that state legislatures---e.g.,- most recently New Jersey's---are finding it necessary to go back and amend or propose amendments to some of their laws' more unworkable provisions. CFAL believes that it is very important for Committee members to understand that such purported "fixes" have not necessarily actually fixed the liquidity problems or other problems caused by these state statutes which have forced nonprime lenders to exit these markets or substantially curtail their lending activity.

In reality, what has happened is that state law "high cost" triggers tend to operate in the market as de facto usury ceilings; accordingly, virtually no so-called "high cost" loans are being made by lenders or sold into the secondary market. When Georgia, for example, moved to change its statute, the Legislature still applied onerous provisions, including broad assignee liability, to all loans that qualified as "high cost" under their triggers. This means that there is still no liquidity for "high cost" loans in that state. The same thing is currently occurring in New Jersey. Simply put, many legitimate loans that would exceed the interest rate and/or the points and fees trigger thresholds if priced fairly on the basis of the credit risk involved now generally are not made because the assignee liability risk is too great for secondary market participants.

Rating agencies also have difficulty rating loans that are subject to such requirements, and to the extent that they can provide a rating, credit enhancements may be required to the degree that such loans are not economically viable.

Investors like clarity and are typically risk-averse, and it should surprise no one that they are unwilling or extremely reluctant to invest in loans (and charge a high risk premium) where requirements are vague and violations can prove to be extremely costly and where they have no acceptable way to limit their risks. Lenders likewise are generally unwilling to make such loans----as they can neither sell them into the secondary market, nor tolerate the high level of risk they face if the loans are retained in their own portfolio.

HOEPA Assignee Liability Requirements Also Undercut Liquidity And Limit Nonprime Credit Availability

Industry experience under the federal Home Ownership and Equity Protection Act of 1994 ("HOEPA") also demonstrates how easily market liquidity is disrupted by broad assignee liability requirements. Relatively speaking, especially when compared to many state statutes, HOEPA's requirements for loan originators are quite modest and for the most part are not difficult for lenders to meet.[6] The primary problem legitimate lenders seem to encounter with this law is when they do not realize that a loan exceeds HOEPA's "high cost" triggers, typically due to calculation error, and therefore they fail to give the required pre-closing special HOEPA disclosures. A violation subjects the loan to an expanded 3-year right of rescission without any meaningful right to cure such error. Many lenders are unwilling to take this additional legal risk. Moreover, most lenders today also will not make HOEPA loans because many people perceive that such loans are viewed as "predatory." This reputational risk causes lenders to forgo making "high cost" loans even though such loans, like other loans, would be priced on the basis of borrower risk and would meet the needs of consumers who cannot qualify for lower-priced loans. However, not only is credit availability curtailed by many originators' reaction to HOEPA's provisions, but the market is further restricted because almost no one will purchase such loans in the secondary market. This is primarily due to HOEPA's broad assignee liability provisions.

Lenders in the prime and nonprime mortgage markets normally are NOT subject to assignee liability. This longstanding general rule, however, now has been changed by HOEPA and laws in some states (e.g., Georgia; New Jersey) with regard to loans that exceed the rate and/or point and fee trigger thresholds and are deemed "high cost" mortgages. The assignee/purchaser of any such "high cost" loan is subject to liability for violations of the HOEPA statute and some state laws, and for other violations by the originator (e.g., state law fraud claims). In light of this, there is essentially no secondary market liquidity for HOEPA or other "high cost" loans.

[6] See November 5, 2003 statement of Steve Nadon at pp. 6-8.

Clear And Reasonable Uniform Standards Are Needed

In conclusion, CFAL believes that Congress should pass fair, effective, and workable uniform national standards for nonprime mortgage lending. Such standards will help preserve and expand liquidity for nonprime lending and make credit and homeownership more widely available. As explained in more detail earlier, these standards should, among other things:

- ✓ **Provide lenders/purchasers with clear definitions of what is required;**
- ✓ **Mandate lenders/purchasers have a meaningful opportunity to correct errors;**
- ✓ **Impose reasonable penalties that are proportional to the nature of the violation**; and
- ✓ **Require only limited assignee liability.**[7]

* * *

CFAL appreciates the opportunity to present this testimony, and we look forward to continuing to work with Committee members on a bipartisan basis and other interested parties to develop fair and workable uniform national standards, including limited assignee liability provisions, for nonprime mortgage lending.

Please contact Wright Andrews, CFAL's Executive Director, at 202-742-4245 if you have questions, or if we can be of assistance to you on these important issues.

[7] See Appendix "B" containing an example of a possible assignee liability provision that might be incorporated into a new law amending HOEPA.

Appendix "A"

Excerpt from GAO Report, "*Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending*," (January 2004) at pp. 72-74

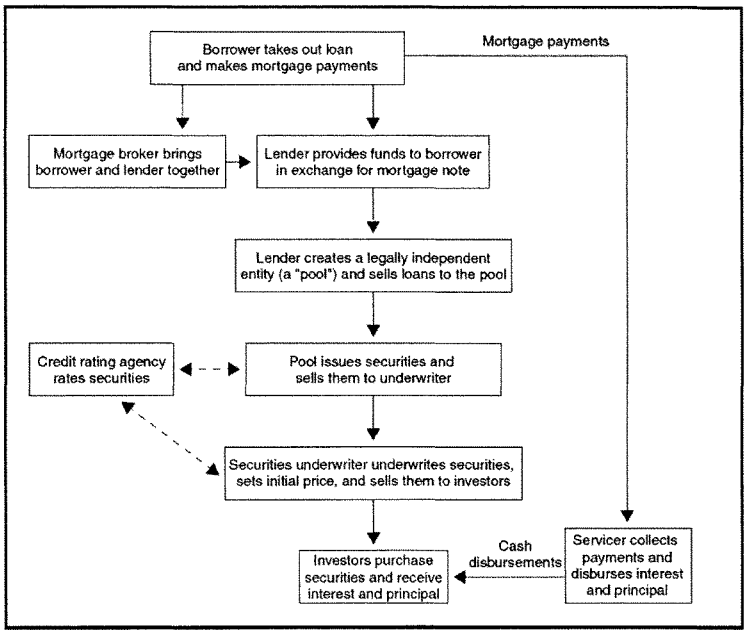
By providing lenders with an additional source of liquidity, the secondary market can benefit borrowers by increasing the availability of credit and, in general, lowering interest rates. While a secondary market for prime mortgage loans has existed for decades, a relatively recent secondary market for subprime loans now offers these potential benefits to subprime borrowers as well. . . .

Originators of mortgage loans—which can include banks, other depository institutions, and mortgage lenders that are not depository institutions—may keep the loans or sell them in the secondary market. Secondary market purchasers may then hold the loans in their own portfolio or may pool together a group of loans and issue a mortgage-backed security that is backed by a pool of such loans. The securitization of mortgage loans became common during the 1980s and, by the 1990s, had become a major source of funding in the prime mortgage market. . . .

The securitization of subprime mortgage loans did not become common until the mid-1990s. The development of a secondary market for these loans has been an important factor in the growth of subprime lending, expanding subprime lenders' access to funds and thus increasing the availability of subprime credit. The trade journal Inside B&C Lending estimated that in 2002 approximately 63 percent of new subprime mortgages, representing $134 billion, were securitized. The originators of subprime loans are often nonbank mortgage and finance companies. As secondary market participants—such as the Wall Street investment firms that have been the major underwriters for subprime securities—have grown more willing to purchase these instruments, subprime originators have gained access to an important source of liquidity that has allowed them to make more subprime loans.

As shown in figure 4, the process of securitization starts with borrowers obtaining mortgages either directly from a lender or through a broker. The lender then creates a pool—a separate legal entity that purchases the mortgages and issues securities based on them. The lender hires a credit rating agency, which has no direct financial interest in the deal, to confirm the value of the securities based on the expected return and risks of the underlying mortgages. At the same time, the lender hires an underwriter to sell the securities to investors. The value of the securities is based exclusively on the mortgages themselves and is separate from the financial condition of the original lender. Finally, a servicer is hired to collect mortgage payments from the borrowers and disburse interest and principal payments to the investors. The process described above is for securitizations performed via private conduits—that is, without the participation of government-sponsored enterprises.

Figure 4: Steps in the Securitization of Residential Mortgages



Source: GAO.

Note: This chart represents the process for fully private securitizations and not for government-sponsored enterprises.

Appendix "B"

POSSIBLE AMENDMENTS RELATING TO LIABILITY OF ASSIGNEES-

RIGHTS UPON ASSIGNMENT OF HIGH-COST MORTGAGES- Section 131(d) of the Truth in Lending Act (15 U.S.C. 1641(d)) is amended—

(A) by re-designating paragraphs (3) and (4) as paragraphs (4) and (5), respectively; and

(B) by striking paragraphs (1) and (2) and inserting the following new paragraphs:

'(1) IN GENERAL- Any person who purchases or is otherwise assigned a high-cost mortgage shall be subject, in an individual action only, to all affirmative claims and defenses with respect to that mortgage that the consumer could assert against the creditor of the mortgage, unless the purchaser or assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence could not determine with reasonable certainty, based on information contained in the documentation required by this title, the itemization of the amount financed, and other disclosure of disbursements, that a violation of this title or other applicable law had occurred. The preceding sentence does not affect rights of a consumer under subsection (a), (b), or (c) of this section or any other provision of this title. For purposes of this section, it shall be presumed that a purchaser or assignee has exercised such due diligence if the purchaser or assignee demonstrates by a preponderance of the evidence that it: (1) has in place, at the time of the purchase or assignment of the loan, policies that expressly prohibit its purchase or acceptance of assignment of any high-cost mortgage containing such violations; (2) requires by contract that a seller or assignor of home loans to the purchaser or assignee represents and warrants to the purchaser or assignee that either (a) it will not sell or assign any high-cost mortgage to the purchaser or assignee that contain such violations or (b) that the seller or assignor is a beneficiary of a representation and warranty from a previous seller or assignor to that effect; and (3) exercises reasonable due diligence, based on a reasonable sample of loans at or before the time of purchase or assignment of home loans or within a reasonable period of time thereafter, to prevent the purchaser or assignee from purchasing or taking assignment of any high-cost mortgage containing such violations.

'(2) Notwithstanding any other provision of law, relief provided as a result of any action made permissible by paragraph (1) may not exceed the greater of–
'(A) with respect to actions based upon a violation of this title, the amount specified in section 130; or
'(B) with respect to other actions, the sum of (i) the amount of all remaining indebtedness; and (ii) the total amount paid by the consumer in connection with the transaction; and
'(C) provided, however, in the case of either (2)(A) or (2)(B), in determining the amount of the award, the court shall consider, among other relevant factors, the amount of any actual damages awarded and the extent to which the damages are non-compensatory and designed to punish or deter future conduct of the purchaser or assignee, the lack of such purchaser's or assignee's knowledge of or participation in the facts or circumstances giving rise to the violations and claim and defenses, the materiality of the violation, the steps taken to cure the violation, the relative harm to the consumer, and the financial resources of the purchaser or assignee.

'(3) CLARIFICATION OF TERMS- For purposes of determining the liability of assignees under this Section, the terms `purchaser' and `assignee' shall not include—
'(A) persons whose interest in high-cost mortgages is limited to a security interest or who acquire title as a result of the foreclosure of such security interest;
'(B) broker dealers that trade in mortgage loans and related mortgage securities and otherwise are not involved in any material respect in the terms and conditions under which such mortgage loans were made or such securities were issued; or
'(C) passive investors in securities or interests in securities based on and backed by a pool of residential mortgage loans.'.

Statement of Freddie Mac

Submitted to the Subcommittee on Housing and Community Opportunity

and

the Subcommittee on Financial Institutions and Consumer Credit

of the House of Representatives

For the Joint Hearing
"Promoting Homeownership by Ensuring Liquidity in the Subprime Mortgage Market"

June 23, 2004

Freddie Mac appreciates the opportunity to share our views on promoting homeownership by ensuring liquidity in the subprime mortgage market.

We commend the Subcommittees for their leadership in promoting responsible lending practices throughout the mortgage market. This hearing will help bring to light the important issues that must be considered as the Subcommittees consider how to balance the interests of consumers, lenders, secondary market companies and others in promoting homeownership through developing and maintaining liquidity in the subprime sector of the residential mortgage market.

Freddie Mac's mission is to bring liquidity and stability to the entire spectrum of the conforming residential mortgage market. We are a company dedicated to expanding affordable homeownership and rental housing opportunities.

As the mortgage market landscape has changed over time, Freddie Mac has remained steadfast in our commitment to making the mortgage market safer, especially for borrowers who might be vulnerable to the abusive lending practices that are often linked to the subprime sector of the residential mortgage market. Our resolve is evident: we are a leader in developing and promoting responsible mortgage lending practices and we have instituted the secondary mortgage market's most comprehensive set of measures designed to protect consumers from predatory lending practices.

Our statement today describes our congressional charter purposes and our leadership role in promoting responsible lending practices. We conclude our statement with a set of the principles we believe could help frame consideration of legislation to fight predatory lending practices.

Freddie Mac promotes liquidity in the residential mortgage market

The Congress chartered Freddie Mac in 1970 to expand opportunities for homeownership by establishing and maintaining a national secondary market for conforming residential mortgages. In our charter, Congress articulates four purposes for Freddie Mac:

- Provide stability in the secondary market for residential mortgages
- Respond appropriately to the private capital market
- Provide ongoing assistance to the secondary market for residential mortgages (including mortgages on housing for low-and moderate-income families) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing
- Promote access to mortgage credit throughout the nation (including central cities, rural areas, and other underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing[1]

[1] Freddie Mac Act, Section 301(b).

We fulfill these purposes by purchasing conforming residential mortgages from lenders in all geographic areas and during all economic environments. We finance our mortgage purchases by selling mortgage-backed and debt securities to investors worldwide. By purchasing residential mortgages and by maintaining a deep and broad investor base to finance these mortgage purchases, Freddie Mac ensures that lenders have an uninterrupted source of funds for mortgage lending and saves American families billions of dollars in mortgage costs. In short, we ensure a stable supply of low-cost mortgages for America's families – whenever and wherever they need them.

Our business activities are vital to ensuring the continuous supply of funding to support America's housing finance system. During 2003, average daily mortgage loan originations equaled $15 billion – meaning that 90,000 homes were purchased or refinanced every business day.[2] Freddie Mac's funding of 20 percent of total 2003 single-family originations – $731 billion of single-family mortgages – played a central role in supporting record mortgage volumes.[3]

Freddie Mac's activities benefit borrowers by increasing the availability, and lowering the cost, of mortgage credit. Working closely with our mortgage Sellers and Servicers, we have helped increase the homeownership rate in the United States to record levels.[4] From our perspective, that's good, but not good enough: we are a housing mission-driven company committed to ensuring that liquid, stable and maximally accessible residential mortgage finance is available so that everyone may have access to housing opportunities. We are using our expertise, innovation and access to capital to help more families become homeowners, including those with blemished credit and little or no credit history.

Freddie Mac is committed to the fight against predatory lending practices

Freddie Mac began purchasing subprime loans during 1997.[5] In that year, we began a thorough exploration of the subprime market to help us understand better the market's

[2] The average daily origination amount is based upon $3.7 trillion in single-family originations during 250 business days in 2003 with an average loan amount of $165,000. *See* "Opening Doors for America's Families," Freddie Mac's Annual Housing Activities Report for 2003, March 15, 2004, page 11.
[3] *See* "Opening Doors for America's Families," page 11.

[4] On June 17, 2002, President George W. Bush called on the nation's housing industry to expand homeownership opportunities to help 5.5 million minority families become homeowners this decade. Freddie Mac immediately responded to the President's call with a comprehensive set of initiatives that target the homebuying process. We call our initiatives "Catch the Dream." The goal is simple: turn the dream of homeownership into a reality for millions more of America's families.

[5] A subprime loan is one offered to people who have problems with their credit or who lack a financial track record. The interest rate on a subprime loan is typically higher than the prevailing rate available to those with exemplary or established credit histories. Subprime loans are sometimes a legitimate way to help people with poor credit or no credit achieve homeownership. However, forcing people into a subprime loan when they could obtain a loan in the prime mortgage loan market is a kind of predatory lending. Additional information on subprime lending and Freddie Mac's corporate initiatives is available at www.freddiemac.com/corporate/initiatives.

characteristics and features. We have learned a great deal since 1997 about how to increase affordable homeownership opportunities and protect against abusive lending practices, and we have used this knowledge in developing a comprehensive set of measures designed to protect consumers from predatory lending practices.

Freddie Mac is opposed to abusive and unfair home lending practices that strip wealth and equity from homeowners; we actively fight predatory lending practices. We have worked, and continue to work, with our mortgage Sellers and Servicers, with Community Development Lending partners and with other participants in the mortgage industry to create homeownership opportunities for underserved families, reduce mortgage costs, raise industry awareness of predatory lending practices and alert potential borrowers to the dangers of predatory lending.

We hold our mortgage sellers and servicers to stringent standards

Before Freddie Mac will purchase mortgage loans from an institution, or allow an institution to service mortgage loans for Freddie Mac, the institution must meet our eligibility requirements.

Our institutional eligibility requirements help ensure that the companies that sell or service mortgage loans for us have the organizational structure, financial resources, quality controls and personnel expertise to originate and service mortgages that are acceptable to Freddie Mac. We perform background reviews of an institution's management by checking records of various regulatory, licensing, and court authorities. In these ways, Freddie Mac seeks to verify that the management and business practices of the mortgage loan Sellers and Servicers with whom we do business are sound and reputable.

A Freddie Mac mortgage loan Seller or Servicer must originate and service mortgages at all times in accordance with the requirements in Freddie Mac's Single-Family Seller/Servicer Guide[6] and other contract requirements.

Our Guide promotes sound business practices such as requiring our mortgage Sellers to employ best practices that promote fair lending.

We strongly encourage our mortgage Sellers to inform potential borrowers about all mortgage products for which they qualify so that borrowers may select the mortgage product that best meets their housing finance needs. Potential borrowers should be directed to a mortgage Seller's standard mortgage product line if the borrower qualifies for a standard product and should not be referred or "steered" to higher-cost mortgage products.

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[6] Freddie Mac requires each mortgage Seller to represent and warrant to Freddie Mac that the mortgages they sell to Freddie Mac—whether originated by the Seller or by a third party—comply with Freddie Mac's Guide and other contract requirements and were originated in accordance with all applicable laws and regulations.

We also expect our mortgage Sellers to have guidelines and procedures that address the reasonableness of the fees charged a borrower when a mortgage is originated and to apply these guidelines consistently.

Our corporate policies, educational efforts and mortgage products help fight predatory lending

Freddie Mac has instituted the secondary mortgage market's most comprehensive set of measures designed to protect consumers from predatory lending practices.[7] These measures include corporate policies, educational campaigns in communities across the country, and targeted mortgage products.

Freddie Mac has adopted policies that demonstrate our firm commitment to promoting responsible lending practices.

- High-cost HOEPA loans – Freddie Mac does not purchase high-rate or high-fee loans that are covered by the Home Ownership and Equity Protection Act of 1994 (HOEPA). Freddie Mac was the first secondary market institution to adopt this policy.

- Mandatory arbitration clauses – Freddie Mac announced in 2003 that, effective August 1, 2004, we would no longer invest in subprime mortgages originated on or after that date that contain mandatory arbitration clauses that deny borrowers access to the court system. Freddie Mac is among the first secondary mortgage investors to adopt such a policy.

- Prepayment penalties – Since 2000, Freddie Mac has not purchased mortgages that impose a prepayment premium for a term of more than five years. In March 2002, we announced that we would no longer purchase sub-prime mortgages with a prepayment premium of more than three years. Freddie Mac was the first secondary market financial institution to adopt such a stringent policy on prepayment mortgages.

- Single premium credit insurance – Freddie Mac does not purchase mortgages containing a prepaid single-premium credit insurance policy obtained in connection with the origination of the mortgage, regardless of whether the premium is financed in the mortgage amount or paid from the borrower's funds.

[7] The Office of the Comptroller of the Currency (OCC) has informed national banks that the secondary mortgage market's guidelines, including the steps Freddie Mac has taken to reduce the possibility of purchasing abusive loans, can serve as a useful guide for national banks in developing their own policies and procedures. OCC Advisory Letter 2003-2, "Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices," February 21, 2003 and OCC Advisory Letter 2003-3, "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans," February 21, 2003.

- Credit reporting – Freddie Mac requires all lenders servicing Freddie Mac loans to report monthly borrower mortgage payments to all four major credit repositories. As a result, the repositories will have on file not only negative information about borrowers who fail to make mortgage payments, but also positive information about borrowers who are making timely payments on their mortgages. This may permit borrowers to obtain lower-cost loans as their credit history improves.

Helping potential borrowers better understand the mortgage lending process is one way we help protect borrowers from predatory lending practices. Freddie Mac has expanded the Don't Borrow Trouble℠ campaign, pioneered in Boston by Boston Mayor Thomas M. Menino and the Massachusetts Community & Banking Council, to reach more than 30 localities nationwide. Don't Borrow Trouble is the first comprehensive consumer awareness and foreclosure prevention campaign of its kind. Don't Borrow Trouble combines an extensive public education campaign with comprehensive counseling services to help homeowners avoid scams and resolve any financial difficulties they may be experiencing in an informed and prudent manner.

Freddie Mac has also taken a leadership role in the development of innovative outreach initiatives designed to provide consumers with information on the use of credit, to make them aware of their financial options and to help them avoid borrowing pitfalls. CreditSmart® and CreditSmart® Español are innovative financial education curricula developed by Freddie Mac in conjunction with several Historically Black Colleges and Universities. These initiatives help consumers understand, build and maintain better credit, thereby preparing them for homeownership and other personal financial goals. CreditSmart® workshops are being provided across the country through our national partnerships.

In addition to these policies and educational programs promoting responsible lending practices, Freddie Mac is also bringing benefits to borrowers who otherwise might fall victim to predatory lending practices by providing a wider range of mortgage products that make credit less costly and more sustainable. We regularly introduce innovative loan products aimed at giving borrowers with impaired credit greater mortgage choices and initiatives that help borrowers avoid the pitfalls of predatory lending.

Principles for consideration of legislation to fight predatory lending practices

Freddie Mac's mission is to promote liquidity and stability in the conforming residential mortgage market. We support anti-predatory lending legislation that is appropriately designed to protect borrowers from abusive lending practices.

Freddie Mac's purchases of subprime mortgage loans have helped bring the efficiencies and lower costs associated with the secondary market for prime loans to the subprime

sector. Our presence in the subprime sector lowers the cost and expands the availability of mortgage credit for subprime borrowers.[8]

We would like to offer a set of principles based on our experiences in purchasing loans originated in the subprime sector of the residential mortgage market. We believe it is important to guard against unintended consequences that could diminish liquidity in the mortgage market and reduce the availability of low-cost mortgage credit.

The following principles could help frame consideration of legislation to fight predatory lending practices. Such legislation should:

- Balance the interests of consumers, lenders, secondary market companies and others in promoting homeownership through developing and maintaining liquidity in the subprime sector of the mortgage market
- Cleary define mortgage loan terms, features or mortgage market practices determined to be predatory or abusive
- Set clear standards that apply to mortgage market participants, including mortgage loan purchasers and assignees, and appropriately distinguish among purchasers and assignees that are in the business of purchasing high cost loans and those that have policies intended to prevent such purchases
- Provide flexibility for mortgage market participants to comply with clearly established standards in a manner determined by the nature and scope of their business operations
- Focus on loan types that are most susceptible to abusive lending practices
- Allow for adaptability to changes in mortgage market conditions
- Limit the scope of liability and prohibit class action lawsuits against secondary market participants that, acting in good faith, unintentionally or inadvertently purchase a high-cost home loan
- Encourage mortgage market participants to engage in voluntary policy initiatives and develop market-based solutions to prevent abusive or predatory lending practices

[8] "Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending," Report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate, General Accounting Office, January 2004, page 75.

Conclusion

Freddie Mac's mission is to promote liquidity and stability across the entire spectrum of the conforming residential mortgage market. We have instituted the secondary mortgage market's most comprehensive set of measures that help make the mortgage market safer for subprime borrowers who might be vulnerable to abusive lending practices.

Freddie Mac looks forward to working with the Subcommittees as you consider legislation to combat predatory lending practices. We support anti-predatory lending legislation that is appropriately designed to protect borrowers from abusive lending practices. We believe it is important that such legislation fully consider the principles we have set forth for guarding against unintended consequences that could diminish liquidity in the mortgage market and reduce the availability of low-cost mortgage credit.

Statement of the Housing Policy Council
Of The Financial Services Roundtable

Before the
Subcommittee on Financial Institutions and Consumer Credit
and the
Subcommittee on Housing and Community Opportunity

On

Promoting Homeownership by Ensuring Liquidity in the
Subprime Mortgage Market

June 23, 2004

Mr. Chairmen and Ranking Members of the Subcommittees on Housing and Community Development and on Financial Institutions and Consumer Credit, the Housing Policy Council of The Financial Services Roundtable is pleased to submit testimony to the Subcommittees on the topic of "Promoting Home Ownership by Ensuring Liquidity in the Subprime Mortgage Market."

The Housing Policy Council is made up of seventeen of the largest mortgage finance companies in the nation. The members of the Roundtable and the Housing Policy Council originate over 65 percent of the residential mortgages in the United States. Our members strongly support the goal of homeownership for all Americans and help millions of consumers meet that goal every year.

The Housing Policy Council strongly supports the enactment of a uniform national standard to prevent predatory lending and our members appreciate the leadership of Chairmen Ney and Bachus and the members of the Subcommittees on this issue. We are pleased the subcommittees are focusing on the secondary market, liquidity, the importance of limiting assignee liability, and whether or not assignees of nonprime loans should be held liable for abusive actions engaged in by the original lenders. The Council believes that in certain circumstances they should, but it would be

a grave mistake to make assignees responsible for the acts of persons over which they have no control and whose acts they cannot detect.

Nonprime Lending – A Major Success Story

The Housing Policy Council supports the expansion of credit to more Americans. It is a positive development that the issues you are addressing today are not the issues we all faced a decade or more ago. At that time, the focus of the debate was on the need to expand the availability of credit. The concern among policy makers was whether lenders were resisting making credit available to those who did not have perfect credit. There was widespread concern about the lack of credit available to many Americans.

Thanks to lenders' efforts, technology, and support from the secondary market the debate has shifted. Credit is widely available to people of all economic status. Today the policy concern is about an overabundance of credit, which some believe is being made available to individuals who should not receive it. The focus of today's debate actually shows that great progress has been made. It is a sign that the effort to extend credit to nonprime borrowers has been a success story. More borrowers than ever before have the opportunity to obtain and make use of

credit. It is the goal of those of us in the industry to continue this success story while trying to eliminate the problems that have come with the successful effort to give more Americans access to credit.

How to Continue That Success

The Housing Policy Council believes that a national law covering nonprime lending, including a clear national standard on assignee liability, would contribute to the ability of its members to continue to extend good credit to more borrowers. While many of our members are currently operating under a wide variety of state laws, the growing proliferation of diverse state and local statutes is causing serious financial and operational problems and has caused some of our members to drastically reduce or shut down their operations altogether in some jurisdictions. Even nationally chartered institutions, that may not be subject to some of the state laws, face reputation and litigation risk. Borrowers and lenders would be best served by Congress reaching a consensus and developing a workable national law just as it did with the reauthorization of the Fair Credit Reporting Act.

In the absence of a national law, lenders face growing problems: (1) a number of states, and even cities and counties, pass widely different

legislation that causes a variety of administrative and legal problems. What is permitted in some locales is not in others, sometimes even within the same state; (2) states and subdivisions begin competing to devise new restrictions; (3) because of the lack of uniformity and great variety of differences between jurisdictions the chances of honest mistakes are compounded and the possibility of litigation is magnified; (4) litigation adversely impacts the reputations of lenders, and (5) lenders decide that making loans in states and municipalities with broad and vague statutes is no longer worth the risk to their reputations, and assignees decide that buying or lending against these loans is also not worth the risk for them. The end result is actually less credit for borrowers.

Investment in companies and industries varies over time as the market constantly revises its determination of which investments produce the best risk returns. While secondary market investors have helped fund the expansion of credit to those who a decade or so ago were unable to get credit, that backing is not inevitable. In recent years, non-prime lending has moved into the mainstream and is being offered by all lenders. However, the effect of many of these new state and local laws will be to reduce the availability of credit in many areas. The first to exit will be the mainstream lenders with good reputations who have entered into nonprime

lending in the past few years. Once the market sees that the risks are excessive, capital will go elsewhere.

The Role of the Secondary Market

An integral part of the supply of capital to the nonprime lending market is the breadth and depth of our secondary market. Originators of loans may keep or sell them in the secondary market. If they keep the loans on their own books, they must have capital to support those investments. However, if they sell those loans, they need less capital to support the originations, and will have additional capital available to make more loans.

A trademark of the U.S. capital markets is their innovation. By creating pools of loans and securitizing them, providing credit enhancements where demanded by the market place, and distributing those securities to individual and institutional investors through an active network of securities brokers and dealers, we have built the capacity within the investor ranks to support the dramatic expansion of our housing market. It is no surprise that the expansion of the nonprime lending market in the mid-1990s took place simultaneously with the expansion of the securitization of those loans by the secondary market.

Your subcommittees, therefore, are correct in considering the role of the secondary markets in nonprime lending, understanding how determinations are made which effect investors' willingness to invest in these securities, rating agencies' willingness to rate or to reach a sufficiently good rating, the willingness of lenders to sell their loans into the secondary market, and the willingness of assignees to purchase or lend against these loans.

It is important to understand that the market is comprised of different players, each intent upon doing its job correctly. Lenders in the primary market advance the funds in the first place and legitimately expect to be repaid. Similarly, investors in those loans such as mutual funds, pension funds and insurance companies expect their funds to be repaid and earn a return. Rating agencies help investors determine the risks they will assume with the securities created from the loans. The distribution network which sells the securities must continue to satisfy their customer's expectations. The most critical factor underlying this process is the ability to reasonably measure risks and accurately predict the performance of the loan pools. Risk that is measurable may be served by the capital markets, albeit at a higher cost. Risk that is unpredictable will not.

How does the secondary market work?

The secondary market is based upon an assignment of loans from originators to third parties. If loans are held in portfolio and not assigned, there is no secondary market. However, most are assigned and questions about the liability of assignees go to the heart of the operation of the secondary market.

Whether assigned or held in portfolio, loans undergo a process of due diligence designed to minimize legal, financial, and reputation risk associated with the purchase of the loans.

Loans are seldom, if ever, purchased singularly, but instead are purchased in pools. The assignee diligently reviews the loans to ensure they are creditworthy and in compliance with any applicable laws. The first line of diligence is to ensure that the party from whom they purchased the loans is reputable and financially sound. They then review and appraise the legal and financial information related to the loans themselves, containing information such as loan amount, interest rate, and borrower's credit score. Often the purchaser will review a sample of the loan files including the loan application and settlement forms.

This due diligence review is designed to prevent purchasing loans of an inferior credit quality, that have too high a risk of defaulting, or which

carry the stigma of "predatory loans," among others. HPC member companies do not want to purchase those loans.

Many of our members will not purchase or originate "high cost loans" as defined in the Home Owner's Equity Protection Act or state laws because doing so could expose them to allegations of purchasing "predatory" loans. Mortgage market participants refuse to make or purchase such loans not because the loans may not pass reasonable underwriting standards for companies, but because the existing assignee liability provisions of HOEPA are extremely broad and there is a concern that the reputation of the firm will be sullied by buying or originating HOEPA loans. In other words, HOEPA has driven a number of reputation conscious lenders out of the high cost loan market.

While due diligence is designed to determine if the purchased loans comply with applicable laws, it cannot uncover some terms, conditions or practices which are predatory. For example, due diligence generally cannot detect cases of fraud by the borrower, broker or originator. If false income amounts are inserted in an application in order to meet an income requirement and supported by phony verifications, due diligence most likely will not detect the false statement. Similarly, "flipping", or repeatedly

refinancing a loan, may go undetected because loan files do not generally include information on previous refinancings.

What is the effect of making assignees liable for the predatory lending practices of originators?

Should assignees be required to bear the responsibility for the predatory practices of those from whom they purchase loans?

It is clear that if the liability is broad and does not provide solid, safe harbors and limits on liabilities, lenders will refrain from purchasing a broad category of loans. This is because the risk of acquiring the loan has become too great, not because each of the loans in that category may be predatory. This means that many lenders will not originate high cost loans and purchasers will not purchase them. They will not be securitized and the secondary market will not produce the liquidity that fuels additional lending in the high cost loan market.

Similarly, if credit rating agencies are unable to measure the possible costs to the purchasers of a pool of loans, they will be unable to rate them, and purchasers are loath to purchase unrated securities at any price. In those cases there will be a dramatic decrease in the secondary market such as that which occurred in Georgia and the District of Columbia when overly-broad or ill-defined nonprime lending laws were passed.

Rating agencies flounder over undefined terms such as "tangible benefit" or "reasonable net tangible benefit" because it is difficult to predict how a court might rule on a case involving such terms. If class actions can be brought against assignees, the agencies again will be unable to measure the risk to the investors.

Even when the securities can be rated, if the risk is such that very expensive enhancements, such as more insurance, additional collateral, etc., must be added, it does not mean that the loans will be originated, or investors will buy the securities. Excessive required enhancements have the same practical effect as the inability to rate securities. Investors are concerned about securities in which the comments of the rating agencies point out myriad additional risks and then require major enhancements. Investors may just buy government bonds instead, which reduces the funding for future mortgage loans.

These are not hypothetical arguments. Standard & Poors, one of the leading rating agencies, recently clarified in a Lending Alert dated May 13, 2004, that it will not rate loans governed by the Georgia Fair Lending Act as it existed prior to its March 7, 2003 amendments, the High Cost Loans defined in the New Jersey predatory and abusive lending law, or loans originated under the Los Angeles and Oakland, CA predatory and abusive

lending laws if and when these laws become effective. In addition, it announced that loans made under various state laws will require additional credit enhancements to be rated, ranging to as much as 163 percent of the price of such a loan governed by the law of the state of New York. Inevitably this reflection of the risks in these laws will reduce the origination of mortgages covered by these statutes. Thousands of homebuyers will simply be unable to get loans at a manageable price.

The Housing Policy Council urges Congress to adopt a national law that provides the secondary market with a clear and well-defined set of laws under which to operate in all jurisdictions, including laws that appropriately limit the conditions under which liability is assessed against assignees. This will provide an impetus for the secondary market to continue to provide the liquidity that is vital to the continued expansion of home ownership opportunities.

Some suggested guidelines for assignee liability provisions in national non-prime lending legislation

The Housing Policy Council does not suggest that there should be no restrictions at all placed upon assignees. We believe, however, that there

should be a limit on restrictions. Restrictions should not prevent the continuation of the liquidity provided by the secondary market.

- Assignees should always have access to a workable, self-executing safe harbor so that they can safely operate with the certainty that there are no undefined terms, that commercially acceptable due diligence procedures are acceptable, and that the existence of the safe harbor does not depend upon the judgment of a third party.
- Causes of action or defenses that borrowers can assert against assignees of high-cost home loans must be related specifically to violations of the law defining those loans, and particularly only to those terms of the law that the assignee could reasonably detect through commercially accepted due diligence practices, including appropriate reviews of the face of the documents.
- Actions and defenses must be limited to those that are based on actual knowledge of the assignee of the existence of the violations in the loans assigned to them, or intentional failure to use appropriate due diligence in reviewing the loans assigned.
- Any action must be limited to individual actions, not class actions.

Thank you for the opportunity to present this testimony. We would be happy to provide the Committee with suggested language on assignee liability provisions for its consideration at the appropriate time. The Housing Policy Council looks forward to working with the Financial Services Committee to enact legislation that protects consumers and enables lenders to serve them in an efficient and productive manner.

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