SUBPRIME AND PREDATORY LENDING: NEW REGULATORY GUIDANCE, CURRENT MARKET CONDITIONS, AND EFFECTS ON REGULATED FINANCIAL INSTITUTIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

MARCH 27, 2007

Printed for the use of the Committee on Financial Services

Serial No. 110–18

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CONTENTS

	Page
Hearing held on:	
March 27, 2007	1
Appendix:	
March 27, 2007	67

WITNESSES

TUESDAY, MARCH 27, 2007

Antonakes, Steven L., Commissioner of Banks, Massachusetts Division of Banks, on behalf of the Conference of State Banking Supervisors	15
Bair, Hon. Sheila C., Chairwoman, Federal Deposit Insurance Corporation	6
Braunstein, Sandra F., Director, Division of Consumer and Community Affairs, Federal Reserve Board	13
Calhoun, Michael D., President, Center for Responsible Lending	49
Dinham, Harry H., CMC, President, National Association of Mortgage Brokers	55
Fishbein, Allen, Director of Housing and Credit Policy, Consumer Federation of America	52
Johnson, Hon. JoAnn, Chairman, National Credit Union Administration	10
Pollock, Alex J., resident fellow, American Enterprise Institute	57
Reich, Hon. John M., Director, Office of Thrift Supervision	8
Robbins, John M., Chairman, Mortgage Bankers Association	54
Rushton, Emory W., Senior Deputy Comptroller, Office of the Comptroller of the Currency	12
Silver, Josh, Vice President of Research and Policy, National Community Reinvestment Coalition	51

APPENDIX

Prepared statements:	
Antonakes, Steven L.	244
Bair, Hon. Sheila C.	68
Braunstein, Sandra F.	217
Calhoun, Michael D.	288
Dinham, Harry H.	392
Fishbein, Allen	346
Johnson, Hon. JoAnn	118
Pollock, Alex J.	428
Reich, Hon. John M.	97
Robbins, John M.	360
Rushton, Emory W.	183
Silver, Josh	315

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Statement of the Consumer Mortgage Coalition	440
Letter to Chairwoman Maloney and Ranking Member Gillmor from the National Association of Federal Credit Unions	457
Statement of the National Association of Realtors	459
Series of newspaper articles from the Charlotte Observer	467
Responses from the Comptroller of the Currency to questions submitted by Hon. Brad Miller	483
Responses from the Federal Deposit Insurance Corporation to questions submitted by Hon. Tom Price	490

Page

Responses from the Board of Governors of the Federal Reserve System to questions submitted by Hon. Tom Price 494
Responses from the Center for Responsible Lending to questions submitted by Hon. Tom Price 498
Responses from the Comptroller of the Currency to questions submitted by Hon. Tom Price 507

SUBPRIME AND PREDATORY LENDING: NEW REGULATORY GUIDANCE, CURRENT MARKET CONDITIONS, AND EFFECTS ON REGULATED FINANCIAL INSTITUTIONS

Tuesday, March 27, 2007

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

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Carolyn B. Maloney [chairwoman of the subcommittee] presiding.

Present: Representatives Maloney, Watt, Sherman, Gutierrez, Moore of Kansas, Hinojosa, McCarthy, Baca, Green, Clay, Miller of North Carolina, Scott, Cleaver, Bean, Davis of Tennessee, Ellison, Klein, Perlmutter; Gillmor, Price, Pryce, Castle, Biggert, Capito, Hensarling, Neugebauer, McHenry, and Campbell.

Also present: Representative Bachus.

Chairwoman MALONEY. This hearing of the Subcommittee on Financial Institutions and Consumer Credit entitled "Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Institutions" will come to order. Without objection, all members' opening statements will be made part of the record. We have two very distinguished panels in front of us today and a very key topic to discuss. Unfortunately, we must give up this room promptly at 1:45, so the ranking member and I have agreed to limit opening statements to the Chair and ranking member of the full committee and of this subcommittee. And we are going to do everything we can do in our power to end the first panel by 12:30 so that we can hear from the second panel.

This first hearing of the Financial Institutions and Consumer Credit Subcommittee in the 110th Congress addresses a critical and escalated issue. We are facing, by all accounts, a tsunami of defaults and foreclosures in the primary subprime market. In each of our districts, our constituents are encountering payment shock as their initial teaser rate ends and their loan is reset to a higher rate. This is happening at the same time homeowners are having a more difficult time refinancing because their homes are no longer increasing in value so they are defaulting and going into foreclosure and losing their homes. Every analyst says that the third quarter of this year and the fourth could be even worse than the rates of default and foreclosure that we have seen to date. By some

estimates, 2.2 million homeowners with subprime loans made through 2006 will lose their homes. As this chart shows, rates of default and foreclosure, which were decreasing, are now on a sharp increase. We also have a dramatic increase in the number of subprime loans being packaged into securities from less than 8 percent of the market in 2001 to 20 percent last year, a more than doubling in 5 years. In the last month, a very significant downward market correction is taking place in the secondary market. Yesterday, for example, Morgan Stanley announced it was auctioning off almost $2.5 billion worth of subprime mortgages from New Century, one of the largest subprime lenders. At least four large subprime lenders are already in bankruptcy. The debate has moved on to whether the turmoil in the subprime market will infect the larger economy.

Against that backdrop, this hearing takes on as its starting point the proposed guidance on subprime lending issued jointly on March 2nd by the five banking Federal regulators, all of whom are testifying today. This guidance has been endorsed by the Conference of State Bank Regulators. The guidance is simple, commonsense: Do not make loans people cannot repay. It sets out principles for subprime lending, which require lenders to assess a borrowers' ability to pay over the whole life of the loan, that is whether the borrower can pay the loan at its fully indexed rate, assuming a fully amortized payment schedule. The guidance requires proof of income and ability to pay, ending no-doc loans or as they are called in the business, "liar loans." At the same time, it allows for flexibility and underwriting for those who may not have the traditional indicators of good credit. This guidance tries to strike a balance; we want to maximize the dream of homeownership while minimizing foreclosures.

This is a first in a series of hearings planned for this topic. With legislation in mind, I have questions for both panels that go beyond the guidance itself to what I consider the larger picture. As this chart shows, only about a quarter of the primary market in subprime loans is directly regulated by the Federal banking regulators. Another quarter, consisting of mortgage subsidiaries of bank holding companies, is indirectly regulated by the Fed. And about half, consisting of State regulated banks and finance companies, is regulated by a patchwork of State laws.

Assuming the proposed guidance goes into effect for the federally regulated quarter of the market, how can it reach the other three quarters? That is the essential question of this hearing. Some suggestions have been made, and I would like the witnesses to comment on them. First, as Federal officials have said, and as Senator Dodd has pointed out, the Federal Reserve has broad powers under HOEPA, the Home Ownership and Equity Protection Act, to regulate unfair and deceptive practices for all lenders. Should the Fed use those powers to extend this guidance to the entire market? I understand that some of the regulators support such a move. Secondly, who could enforce that for each of the different sectors? Also, what about the suggestion of extending the Fed's direct regulatory powers to the mortgage subsidiaries of bank holding companies so that quarter of the market also has to follow the principles of the guidance. And next what about the State banking regulators, can

they act to promulgate the principles of the guidance nationwide or should we have a national subprime standard tracking the guidance and, if so, who should enforce that?

I am interested in knowing how to extend the guidance to the secondary market. Lenders will not make these loans if they cannot sell them. I believe that the GSEs as leaders in the secondary market should stop buying loans that do not conform to the guidance, as Freddie Mac has already done. How do you think we can best extend the principles of the guidance, not only to the GSEs but also to the other secondary market participants? Finally, what can we do to help current borrowers in a responsible manner? The regulators have encouraged lenders to exercise forbearance, but how do they plan to implement that policy, and can Congress help support that effort? I know that Senator Dodd is calling together many of the participants to come forward with a plan.

These are pressing problems requiring prompt attention. Of course, we wish the regulators had acted sooner, but I applaud them for having taken this first step, and I look forward to their testimony. I now recognize the ranking member, Mr. Gillmor, for 10 minutes.

Mr. GILLMOR. I would like to thank the Chair for calling what is a very important hearing today and also I am delighted to see such a distinguished panel. I look forward to working with the Chair and others in Congress on this very important public policy concern.

I think it is prudent that the committee begin its investigation into predatory and subprime lending by looking into how we got here and what the regulators have done to date. The title points it out but I think it is critical that the committee distinguish between these two types of lending; predatory lending and subprime lending are two different animals. Some in Congress and some in the press have blurred the line between the issues but they are distinct problems requiring distinct solutions. In the subprime area, there is no doubt that the past several years have seen a general loosening of underwriting standards. America has one of the highest rates of homeownership in the world. That is good. And we ought to continue to encourage homeownership. However, you are not doing anyone a favor by putting them in a house with a type of mortgage that when interest rates go up, or when they have an economic reverse, they are thrown out of their house.

During then-Chairman Greenspan's and Chairman Bernanke's appearances before the committee previously, I have made it a point to repeatedly voice my concern regarding the proliferation of interest-only and other alternative mortgage products, including those with negative amortization. After interest rates began rising and the housing market began cooling, mortgage originators were pressured by the market to match the volume of the height of the boom. This was too often accomplished through a loosening of credit standards and clearly consumers were put into homes they could not afford just 2 or 3 years down the road. Today, we find ourselves on the leading edge of a market correction that has the potential to harm many Americans. Some 20 subprime lenders have already gone out of business. There will be pressures placed on Congress to react swiftly to correct for the problems of subprime loans. And

while it is a serious problem, I think it is important that we take the time to do it right and not be too hasty and do it wrong. And I am pleased to yield to the distinguished ranking member of the full committee, Mr. Bachus.

Mr. BACHUS. I thank you, Mr. Gillmor, and I also thank Chairwoman Maloney for having this hearing and I look forward to hearing from our panelists. I think when we talk about subprime lending, the first thing we ought to focus on is the benefits of homeownership. I quote President Lyndon Johnson, he said, "For many families homeownership is a source of pride and satisfaction of commitment to community life." The benefits of homeownership are profound when it comes to not only families but also communities and our Nation as a whole. I think that is really why I know regulators, the Administration, this Congress, we have all set as a priority homeownership for as many Americans who have the ability and the desire to own their own home. It improves the educational performances of the children whose parents own homes and it reduces crime rates—the higher homeownership goes, the lower the crime rates go. And over the last probably 30 years or 40 years there has been a recognition that all of our families, whether they are low income or low middle income, should have the opportunity to participate, have the opportunity to own their own home. It is kind of interesting that one of the origins of subprime lending actually was in the Community Reinvestment Act of 1977, as far as the statute. The CRA mandates—mandates, not suggests—that banks and thrifts meet the credit needs of all communities in which they are chartered and from which they take deposits, including low- and moderate-income borrowers. And this committee in the past has actually had institutions in and questioned them on their commitment and their participation in extending loans, mortgage loans, to individuals or families which had less than stellar credit ratings or who really did not have good credit ratings, saying that should not eliminate them from being able to purchase a home. So there has actually been quite a lot of suggestion as well as statutory mandate in that regard.

As the chairman said, and as the ranking member said, we have had a skyrocketing, not only of the number of these loans and the percentage of these loans, but we have had so-called innovative new loans, the interest-only loan, the adjustable rate loan. And I know last September the regulators issued guidance and again came back this last month and issued additional guidance. I have looked at that guidance, and I would say that guidance, had it been followed, would have resulted in a reduction in the number of defaults. Last March, I drew up legislation, worked with now-Chairman Frank, and he and I agreed on about 80 or 90 percent of a subprime lending bill. I wish we passed that bill. We had some members who did not want any regulation, and we had other members who wanted more regulation than what was in the bill, so sadly, we were not able to build a consensus. But it is a shame that sometimes we cannot come together and solve our differences. It would have benefitted a lot of Americans who at least in the past 6 or 8 months have taken out loans.

I will say this about the guidance, and the reason that I last March urged this committee to pass a subprime lending bill, some

people said, "The regulators are taking care of that." They are not taking care of it in that there are—they are taking care of the federally-regulated institutions but there are a lot of State institutions, there are States like Alabama, my State, unlike Massachusetts, we are going to have the commissioner of banks from Massachusetts, you all have taken care of a lot of that problem with a strong bill but there are about half of the States out there that have no legislation. There are others where it is a hodgepodge of legislation and it is interfering with people's ability to get loans. So we still need, because the Federal regulators, they do not include regulation of mortgage brokers. And as we found anybody who is listening to the news, studied what has been going on, knows that we need some legislation addressing mortgage brokers. So I know this committee is going to keep up its attempts to at least establish some type of national standard.

I was sort of surprised last night, my bill, the bill that I introduced, and I have a written statement that talks about the different things I did in that bill including look at people's ability to pay, but the one thing about that bill, it was modeled after North Carolina because everybody said that North Carolina was the gold standard. Last night, ABC News had a documentary on the subprime lending market and all the people who had lost money and the highlight of the thing they showcased in that documentary was a community where like 30 or 40 percent of the people in that community have lost their homes. The homebuilder had come in there and he had built these homes and a lot of people had come and they bought these homes and they were underwater, they were losing their homes. Guess where it was? It was in Concord, North Carolina, with a strong State regulatory, so I do not know what happened there. So it obviously shows that even when you have a strong State bill, you have guidance from the Federal Government—I do not know, it would be interesting to know how those loans occurred and what happened and whether it was just maybe outright fraud.

But I do look forward to your testimony. The first line of defense ought to always be the regulators. You are the professionals; we depend on you to address these problems. The only time that I like to see this committee legislate is when you need statutory authority or where you—and I will say this about our bank regulators, I think they have been on top of this issue and other issues, at least they are on top of it now, I will put it that way. But we still need in my mind legislation because we have a lot of State—we have a lot of institutions and mortgage brokers who are not regulated, that your regulation does not reach.

So with that, I would yield back the balance of my time.

Chairwoman MALONEY. The gentleman's time has expired. I yield 2 minutes to Mr. Miller from the great State of North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Madam Chairwoman. In the great bipartisan tradition of this committee, I find myself agreeing with much of what my colleagues on the other side of the aisle have said. I agree with Mr. Gillmor that we do need to be careful in developing legislation in this committee, that we not rush into something because subprime lending is in the head-

lines, but we cannot let the need for careful legislation become an excuse for inaction. We should pass legislation this year, this is something that has been in the works for a long time. I also agree with Mr. Bachus, with whom I had many discussions last year about this issue, that we need to continue to support homeownership by the middle class. Homeownership is the single best way that the middle class builds wealth, by buying a home, by faithfully paying a mortgage month after month, by building equity in a home, the equity they build becomes the bulk of their life savings. The savings rate for families now is slightly less than zero. We cannot take away homeownership as a way for the middle class to build wealth. A healthy mortgage market helps middle-class families build wealth by owning a home. It also makes it possible for them to borrow money against their home when they face one of life's rainy days. But we have had in this country too much lending that does not help middle-class families build wealth but steals wealth from them, predatory loans that strip their equity with up-front costs and fees and loans that a middle-class family cannot possibly repay, so in 2 or 3 years they have to be back borrowing money again, again paying up-front costs and fees, losing more and more of their life savings. We have the example of many States that have provided effective consumer protections and have struck a balance that middle-class families, they need to borrow money to buy a home and need to borrow money against their home to deal with life's rainy days. And we should follow and look closely at the example of those States and develop a strong national standard that protects every American consumer everywhere. Thank you.

Chairwoman MALONEY. Thank you. I would like now to introduce the panel. They are all distinguished. They have distinguished resumes. We are going to put all of the resumes in the record in the interest of time. I would first like to introduce the Honorable Sheila Bair, Chairwoman of the Federal Deposit Insurance Corporation, for 5 minutes.

STATEMENT OF THE HONORABLE SHEILA C. BAIR, CHAIRWOMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you, Madam Chairwoman, Ranking Member Gillmor, and members of the subcommittee. Thank you for holding this hearing on the important subject of subprime lending and predatory practices in the subprime mortgage market. Homeownership contributes to neighborhood stability and is an important way that many individuals and families build wealth.

Traditionally, homeownership has been a low-risk, stable investment representing the largest asset for the typical family. Government policies, ranging from tax incentives to the formation of government-sponsored enterprises, have long encouraged homeownership in recognition of its important individual and societal benefits. Mortgage lending practices that build debt, rather than wealth, however, not only harm individual homeowners, but also undermine these important social benefits.

The mortgage markets have changed significantly in recent years, especially for subprime mortgages. Intense lender competition, historically low interest rates, rapid home price appreciation and, crucially, investor demand for mortgage paper facilitated the

dramatic growth in the subprime market between 2003 and 2005. New mortgage products were specifically designed to attract borrowers with low initial rates which would then reset to much higher interest rates for the remainder of the loan term. These types of loans were simultaneously attractive both to borrowers, who could obtain larger loans at lower cost for at least a short time, and to investors in mortgage loan pools, who were attracted to the above-market yields. Particularly pervasive were so-called 2/28 and 3/27 hybrid ARMs, which combined a fixed introductory rate for the first 2 to 3 years followed by significant upward adjustments.

There is no doubt that many subprime borrowers have benefitted from the expansion of mortgage credit. However, rather than building wealth, many other borrowers are now struggling to keep their homes. Repeat refinancings have taken equity from their homes and adjustable rate features have challenged their ability to continue making payments. In previous years, many of these borrowers could have refinanced their mortgages or sold their homes at a profit to repay their debt in full. Now, as home prices have stagnated or even declined in many areas of the country, more borrowers find themselves trapped in mortgages they cannot afford to pay.

In 2006, almost three quarters of non-agency securitized subprime mortgage originations were adjustable rate mortgages, primarily 2/28 and 3/27 hybrid ARMs. Estimates are that at least 2.1 million subprime hybrid ARMs are outstanding today. This means that approximately 1.7 percent of U.S. households have 2/28 or 3/27 loans. Subprime borrowers are particularly at risk because they already have very little financial cushion. Subprime borrowers spend nearly 37 percent of their after-tax income on mortgage payments and other costs of housing, roughly 20 percentage points more than prime borrowers spend. Of ARMs originated in 2006, a full 24 percent have negative home equity, in other words, borrowers owe more than their homes are worth. Financial stress on subprime borrowers with adjustable rate mortgages will increase further as rates reset. The FDIC is concerned that the subprime borrowers who have taken these loans will face an array of serious financial problems.

In the past year, the FDIC and the other Federal financial institution regulatory agencies issued guidance regarding the risks of non-traditional mortgages to address concerns about interest-only and payment-option ARMs, which are offered primarily to prime and Alt-A borrowers. Since adjustable rate products in the subprime market raise similar and additional concerns, the Federal banking agencies also proposed a statement on subprime mortgage lending. Both of these documents restate two very fundamental lending principles: A loan should be approved based on a borrowers' ability to repay at the fully indexed rate; and borrowers should be provided with early disclosures to fully understand the costs and terms of the loan. In addition, in January, the FDIC issued a supervisory policy on predatory lending. This policy describes certain characteristics of predatory loans and reaffirms that such practices are inconsistent with safe and sound lending, and undermine individual, family, and community well-being.

The FDIC aggressively addresses predatory lending through examinations and supervisory actions. When examiners encounter loans with predatory characteristics, the FDIC takes whatever supervisory actions are necessary to effect correction. Our examination process has led to the issuance of more than a dozen formal and informal enforcement actions that are currently outstanding against FDIC-supervised institutions that failed to meet prudent mortgage lending standards.

Widespread credit distress in the subprime mortgage market, with especially pronounced problems among independent mortgage lenders, suggests the need for a comprehensive response that assures that all lenders are subject to certain baseline requirements. Guidelines and other supervisory standards promulgated by Federal bank regulators apply to only a portion of the market. Moreover, the lack of uniform standards creates negative competitive pressures on insured institutions. A national anti-predatory lending standard would help assure basic uniform protections for all borrowers as well as create a more level competitive playing field for regulated entities.

There are two possible approaches to creating and implementing an anti-predatory lending standard that would apply across the mortgage lending industry. First, Congress could pass a law that establishes a set of anti-predatory lending standards. A statutory approach to establishing such standards could draw from our current and proposed Federal regulatory guidelines, as well as existing State anti-predatory lending statutes. It should raise the bar by strengthening protections available to borrowers. At its core, it should address at least two important areas; one, the ability of the borrower to repay the loan; and, two, misleading marketing and disclosures that prevent borrowers from fully understanding the costs and terms of loan products. Alternatively, or in conjunction with the statutory process, the Federal Reserve Board could exercise rulemaking authorities it has under the Home Ownership and Equity Protection Act to address abusive practices by all mortgage lenders for all loans, not just those that are high cost. We understand that the Federal Reserve is in the midst of reviewing the regulations that implement this Act. The FDIC would strongly support them should they decide to make greater use of authorities provided by this law.

Many abuses might be more effectively addressed by regulation rather than statute, especially in areas—

Chairwoman MALONEY. The gentlelady's time has expired.

Ms. BAIR. Okay, sorry.

[The prepared statement of Chairman Bair can be found on page 68 of the appendix.]

Chairwoman MALONEY. The Honorable John Reich, Director of the Office of Thrift Supervision.

STATEMENT OF THE HONORABLE JOHN M. REICH, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. REICH. Good morning, Madam Chairwoman, Ranking Member Gillmor, and members of the committee, I am delighted to be here today to have the opportunity to present to you the views of the Office of Thrift Supervision relating to subprime and predatory

lending. I have been involved in the banking business for the past 46 years. During this time, I have witnessed six economic cycles characterized by recession, recovery, growth, and decline. During one turbulent period back in the 1981/1982 time period, the prime rate hit 21 percent, perhaps one of the most alarming periods of my own career in the banking business. These experiences have left me with two steadfast beliefs about banking and bank supervision: one, that you cannot have too much money in your loan loss reserves; and two, you cannot have too much money in your capital account. A further precept that I hold is that you also have to protect your customers for without them you have nothing.

Each of these principles is relevant in the context of today's discussion. Based on these three guideposts, I believe that I can report to you that the vast majority of the institutions that we regulate are conducting their banking activities in a safe and sound manner, consistent with consumer production laws and regulations. However, we are in the midst of a transition in the economic cycle that has troubling activity, particularly from a consumer's standpoint. The result is a difficult correction in response to certain unchecked lending practices.

As Members of Congress, I would expect that you have three major concerns: your constituency; the financial industry that you oversee; and where do we go from here. In my written statement, I detail our oversight of subprime mortgage products and OTS' efforts to combat predatory lending and promote consumer education and financial literacy. I want to speak to the nature of the problem we are facing, the causes of the problem, and some thoughts on how it might be fixed.

First, two issues obviously have been identified, subprime lending and predatory lending, but these are not synonymous. Certainly not all subprime lending is predatory and not all predatory lending is to the subprime market. Appropriately underwritten loans to subprime borrowers are in fact important and legitimate elements of our financial economy. Timely and appropriate regulatory responses can address issues of predatory lending in our regulated financial entities without restricting credit to worthy borrowers. A significant OTS concern, that I believe is shared by all agencies, is striking the right balance. We want to promote responsible lending by the institutions that we regulate. We do not want to divert subprime borrowers to less regulated or unregulated lenders. We need to ensure sound underwriting of subprime loan products, which will help to weed out predatory lending.

Next, the problem of where our subprime lending activities are concentrated; it is not primarily in the thrift industry. Current total national mortgage debt is approximately $10 trillion. Subprime mortgages account for about 13 percent or $1.3 trillion of this amount of the national mortgage debt; 2006 data show that 19 of our 845 thrifts, about 2.2 percent of the total number of thrifts that we supervise, have significant subprime lending operations defined as at least 25 percent of capital. These institutions hold $35 billion in subprime mortgages equal to about 5 percent of total thrift mortgage holdings. Nationwide, there are about 125 subprime lenders out of the total universe of charters of about 8,700, so about 1.4 percent of all institutions nationwide have sig-

nificant subprime programs—loans are originated through mortgage bankers. While there is not consistent data on the number of licensed mortgage brokers in the United States, there are many more individuals working as loan originators and brokers without any type of license or registration. In addition, testing and education requirements are suspect and background checks may be—

Chairwoman MALONEY. The gentleman's time has expired.

[The prepared statement of Director Reich can be found on page 97 of the appendix.]

Chairwoman MALONEY. Next, the Honorable JoAnn Johnson, Chairwoman of the National Credit Union Administration.

STATEMENT OF THE HONORABLE JOANN JOHNSON, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Ms. JOHNSON. Thank you, Madam Chairwoman, and members of the subcommittee. I am Chairman of the National Credit Union Administration, an independent Federal agency that regulates or insures over 8,400 credit unions with 87 million members. Home mortgage lending has long been a part of the way credit unions serve their members. Approximately 68 percent of all federally-insured credit unions offer mortgage loans. Those that do not tend to be small institutions that cannot afford the required expertise or infrastructure. Additionally, the statutory 10 percent loan to one borrower limitation makes it more difficult for a small credit union to grant large mortgage loans. Credit unions represent 9 percent of all mortgage loans outstanding in federally-insured depository institutions. When considering all mortgage lending, including that by non-federally-insured lenders, credit unions originated 2 percent; 61 percent of these credit union mortgage loans are fixed rate, while 39 percent are adjustable.

Because mortgage lending has evolved to now include hybrid or exotic mortgage products, NCUA has modified the way in which we collect information about mortgage lending on our 5300 Report, which is the agency's quarterly reporting tool. This change will enable NCUA to gain more precise information about credit union mortgage lending and will enhance our oversight capability.

The House Financial Services Committee has properly voiced concern about the underwriting standards and quality of consumer disclosures regarding hybrid loans, including 2/28 and 3/27. NCUA shares the committee's concerns about riskier hybrids that may be detrimental to consumers, particularly borrowers in the subprime market. Fortunately, these hybrid loans are not prevalent in credit union portfolios, partially because of the statutory provisions that prohibit prepayment penalties and establish a limit on interest rates.

Demand for mortgages by credit union members remains high. Mortgage loans led all types of loan growth in 2006 and comprise almost half of all credit union loans. Given NCUA's emphasis on safety and soundness, we continue to closely monitor performance indicators in the mortgage lending area. One indicator of a loan's quality, delinquency rates, are relatively low. Delinquencies greater than 30 days are at .99 percent and 60 days stands at .34 percent. Charge-ops, which occur when a borrower cannot pay, are at .03

percent. While these indicators are good, NCUA is committed to a high degree of vigilance in this area.

NCUA has also issued guidance to credit unions on the topic of subprime lending. Beginning in 1995, NCUA recognized the emergency of risk-based lending and outlined the advantages and disadvantages of such lending to borrowers with subprime credit. In 1999 and again in 2004, NCUA reiterated the value of family-managed risk-based lending programs as a way to reach out to all members, including those in the subprime area. At the same time, we reminded credit unions of the importance of stringent underwriting and monitoring processes. Recognizing potential problems in 2005, NCUA specifically addressed emerging risks in exotic mortgage lending by issuing a supervisory alert to all examiners and henceforth to all credit unions. This served notice that NCUA examiners would be monitoring trends in areas of high value appreciation and evaluating both interest rate risks and credit risks associated with these newer mortgage products.

In concert with my fellow Federal regulators, non-traditional mortgage guidance was issued in 2006 and work is now underway on proposed subprime lending guidance. As this new guidance is developed, NCUA is committed to making certain that disclosures are improved and consumer protection strengthened, particularly in helping avoid payment shocks and negative amortizations. Those consumer protections are a vital part of our discussion today. Credit unions must comply with the same Federal regulations governing mortgage lending as do other federally insured institutions, including Truth in Lending, RESPA, OPA, the Federal Disaster Preparedness Act, the Fair Housing Act, and OMDA.

Additionally, NCUA and the credit union industry have devoted significant resources to assist members in disadvantaged communities. This commitment has manifested itself primarily through affordably priced loans and financial education. Regarding financial education, I would strongly suggest that while it is not a panacea, financially literate consumers can be better consumers when it comes to avoiding the pitfalls presented by this rapidly changing market. NCUA administers the—

Chairwoman MALONEY. The gentlelady has 30 seconds remaining.

Ms. JOHNSON.—revolving loan fund, which makes grants to low-income credit unions to assist with financial literacy and wealth building.

NCUA has closely monitored recent dislocation in the subprime market. NCUA is concerned that predatory lending in other areas of the marketplace may increase the debt burden on credit union members and negatively affect credit union asset quality. Even though it represents a relatively small piece of the overall pie, the mortgage lending that credit unions do is safe and sound.

Thank you very much.

[The prepared statement of Chairman Johnson can be found on page 118 of the appendix.]

Chairwoman MALONEY. Thank you. Our next panelist, Mr. Emory Rushton, is the Senior Deputy Comptroller from the Office of the Comptroller of the Currency.

STATEMENT OF EMORY W. RUSHTON, SENIOR DEPUTY COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. RUSHTON. Thank you, Chairwoman Maloney, Ranking Member Gillmor, and members of the subcommittee. I appreciate this opportunity to talk with you about mortgage lending in national banks and our supervision of it, especially subprime lending that is so much in the news today. I bring the perspective of 42 years as a national bank examiner—through good times and bad. During that time, I have had the opportunity to examine banks throughout the country, and I have spent the last decade here in Washington working on bank supervision policy.

We at the OCC are very concerned about the problems in the subprime market. Yet, it is easy to forget in this environment that these loans have enabled millions of Americans, including many low- and moderate-income people, to become homeowners for the first time. Most of these folks are paying their loans on time, and we expect they will continue to do so. Morever, as Ranking Member Gillmor has observed, subprime loans are not inherently predatory or abusive. Those that are have no place in the banking system. When unfair treatment does occur, we in the government have a distinct responsibility to help make it right, and we take that responsibility very seriously. However, OCC bank supervision is aimed primarily at preventing abuse before it occurs, before damage is done.

OCC became concerned in 2002 about the growth of exotic mortgages that carried the potential for a big payment shock, and we responded in an escalating fashion, privately and publicly. By 2005, we were instructing our examiners to more aggressively address the risk of these products during their examinations of national banks because we concluded that standards had slipped far enough. This was at a time, I might add, when home prices were still going up. That intervention is one reason that you will find so few payment-option negatively amortizing loans in national banks today. Shortly after that, we initiated the interagency process that resulted in the non-traditional mortgage guidance that was issued last fall.

Our attention today, though, is focused on the subprime sector and especially on hybrid ARMs, which now make up the bulk of the subprime business. By their very nature, subprime borrowers who take out these loans are especially vulnerable to payment shock. We have addressed this and other key features of these loans in the guidance that is now out for comment.

The subcommittee's invitation letter specifically asked what we expect the results of that guidance to be, both good and bad. To be sure, there needs to be a return to more realistic underwriting standards, and the guidance should have that positive effect. It makes no sense to make loans that cannot be repaid. But we cannot ignore the likelihood that tighter underwriting will mean fewer and smaller loans.

I want to emphasize, Madam Chairwoman, that national banks are not the dominant players in the subprime market. Last year, they produced less than 10 percent of all new subprime mortgages, and their delinquency rates on these loans are about half the in-

dustry average. We know of some institutions that have actually abandoned their plans for a national bank charter rather than subject their subprime lending to supervision by the OCC. But of course these numbers do not matter much to somebody who is facing losing their home through foreclosure. OCC strongly encourages all national banks to work with troubled borrowers to help them resolve their problems.

It is an unfortunate fact, though, that regulatory oversight tends to be less rigorous in precisely those parts of the financial system where practices are most problematic. We hope the guidance that we have proposed will inspire comparable measures by other regulators, as in fact did happen with the nontraditional guidance we issued last fall.

Madam Chairwoman, our capital and credit markets have enabled record levels of homeownership. We play an important role in overseeing those markets and in taking action when necessary to preserve equilibrium and balance. But our authority does not extend to important components of that market, including many originators, aggregators, securitizers, and funding sources.

In conclusion, let me assure you that my colleagues and I intend to preserve bank safety and soundness and fair treatment of customers, and we try to do this through supervision that stems abuse without thwarting healthy innovation. Consumers deserve no less. We look forward to working with the subcommittee on these issues.

[The prepared statement of Comptroller Rushton can be found on page 183 of the appendix.]

Chairwoman MALONEY. Ms. Sandra Braunstein, Director of the Division of Consumer and Community Affairs of the Federal Reserve Bank.

STATEMENT OF SANDRA F. BRAUNSTEIN, DIRECTOR, DIVISION OF CONSUMER AND COMMUNITY AFFAIRS, FEDERAL RESERVE BOARD

Ms. BRAUNSTEIN. Thank you. Chairwoman Maloney, Ranking Member Gillmor, and members of the subcommittee, I appreciate the opportunity to discuss how current subprime practices and products effect homeownership and foreclosure. Subprime lending has grown rapidly in recent years. In 1994, less than 5 percent of mortgage originations were subprime, but by 2005, about 20 percent of new mortgage loans were subprime, many of which were adjustable rate mortgages. Many of these loans have increased homeownership rates. However, the largest recent increase in delinquency and foreclosure rates are for subprime borrowers with ARMs, especially those loans with risk-layering features, such as combining items like low documentation loans with simultaneous seconds. There are indications that the market is addressing these issues for new borrowers by tightening underwriting standards. However, we remain very concerned that over the next 1 to 2 years existing subprime borrowers, especially those with more recently originated ARMs, and those with layered risks, may face more difficulty. As interest rates reset for these loans, some consumers may have difficulty with the larger monthly payments. Therefore increases in foreclosure and delinquency rates are likely to continue.

The Board has taken several actions to address concerns in the subprime market. It is important to remember that overly broad actions run the risk of constricting the market and returning to a situation where some borrowers have very limited access to credit. We want to encourage, not limit, mortgage lending by responsible lenders.

I would like to note several of our activities in this regard. First, the Federal Reserve conducts regular examinations of its institutions for safety and soundness and for compliance with consumer protection laws. When we find problems in these institutions, we require corrective action by bank management and, if necessary, we use enforcement tools to address the problems.

Second, in response to witnesses in underwriting and risk management at the institutions we supervise, we have issued guidance in concert with the other Federal banking agencies. This includes the recent proposed guidance on subprime mortgages. This guidance applies to depository financial institutions and the subsidiaries of banks and bank holding companies. The guidance discusses prudent underwriting practices, including the capacity of the borrower to repay the loan at the fully indexed rate. The guidance also reminds institutions to clearly communicate the risks and features of these products to consumers in a timely manner even before and when application is taken.

Third, in 2001, the Board revised the HOEPA rules in response to renewed concerns about predatory lending. In this rulemaking, the Board utilized its authority to prohibit unfair or deceptive practices. Specifically, the Board issued rules that prohibit a HOEPA lender from refinancing one of its own loans with another HOEPA loan or flipping within the first year. We also adopted a prohibition on demand notes for high cost closed-in mortgages. These revisions to HOEPA are cases where the Board determined that they could write bright line rules prohibiting unfair practices. However, because determination of unfairness or deception depends heavily on the facts of an individual case, it is very difficult to craft rules without unintended consequences. The Board has undertaken a major review of Regulation Z which implements the Truth in Lending Act of which HOEPA is a part. During this review, the Board will determine if there are opportunities to further utilize our HOEPA authority.

Fourth, the Community Affairs offices in the Federal Reserve Banks have responded to mortgage delinquency and foreclose in ways that are directly responsive to the consumer needs in specific markets. Various initiatives conducted in concert with local community partners have identified responsive strategies and helped troubled borrowers. A list of these and other Federal Reserve initiatives are included with my written testimony. We will continue to pursue opportunities to help borrowers and preserve access to responsible lending.

[The prepared statement of Ms. Braunstein can be found on page 217 of the appendix.]

Chairwoman MALONEY. Thank you. Mr. Steven Antonakes, commissioner of the Massachusetts Division of Banks, on behalf of the Conference of State Banking Supervisors. Thank you for being here.

STATEMENT OF STEVEN L. ANTONAKES, COMMISSIONER OF BANKS, MASSACHUSETTS DIVISION OF BANKS, ON BEHALF OF THE CONFERENCE OF STATE BANKING SUPERVISORS

Mr. ANTONAKES. Thank you. Good morning, Madam Chairwoman, Ranking Member Gillmor, and distinguished members of the subcommittee and staff. My name is Steven Antonakes, and I serve as the commissioner of banks for the Commonwealth of Massachusetts. I am also the chairman of the State Liaison Committee, making me the newest voting member of the FDIC. It is my pleasure to testify today on behalf of the Conference of State Bank Supervisors.

The current state of our mortgage market, and the subprime market in particular, have been well covered in the media. What has received less coverage, and is not as well understood, is the interplay between State and Federal mortgage supervision. In addition to regulating banks, 49 States plus the District of Columbia currently provide regulatory oversight of the residential mortgage industry. In recent years, the States have been working diligently to improve supervision in this area.

In addition to the extensive regulatory and legislative efforts, State attorneys general and State regulators have cooperatively pursued unfair and deceptive practices in the mortgage market. Through three nationwide settlements alone, State regulators have returned over $800 million to homeowners. But successes are sometimes better measured by actions that never receive media attention. States routinely examine mortgage companies for compliance not only with State law but for compliance with Federal laws as well. These examinations are an integral part of a balanced regulatory system. Again, in 2006 alone, States took 3,694 enforcement actions against mortgage brokers and mortgage lenders.

In an effort to further improve State supervision of the mortgage industry, significant time and resources have been dedicated to the development of a national mortgage licensing system. Recognizing gaps in mortgage supervision, the States are creating this licensing system to improve the efficiency and the effectiveness of the U.S. mortgage market and to fight mortgage fraud and predatory lending. Scheduled to go live on January 1, 2008, this system will create a single record for every State-licensed mortgage company, branch, and individual.

Despite all the actions taken by the States on an individual basis, and on a coordinated nationwide basis, we are frustrated in our attempts to protect consumers by the preemption of State consumer protection laws. State legislatures have the right to expect the laws they pass to be followed by companies operating in their States. Thirty-seven States have acted by passing predatory lending laws only to have them voided by the OCC and OTS rulings.

In regards to regulatory policy, recent developments have been more positive and more productive. Both the State and Federal guidance on non-traditional mortgage products provide sound underwriting standards and consumer protection provisions. As of today, 29 States plus the District of Columbia have adopted the parallel guidelines developed by CSBS and the American Association of Residential Mortgage Regulators or ARMOR. Ultimately, CSBS expects all 50 States to adopt the guidance. Moreover, CSBS

and ARMOR strongly support the recently proposed interagency statement on subprime mortgage lending. Personally, I would like to thank FDIC Chairman Bair for her leadership on the development of this statement and for ensuring an appropriate role for State supervisors. CSBS and ARMOR are already working to develop a parallel statement for State regulators to use with their supervised entities.

In my written testimony, I have outlined several recommendations for your reference as Congress seeks to improve the residential mortgage market. In addition to Congress' focus, the current challenges for the mortgage industry have drawn State attention as well. As I speak, the Massachusetts legislature is holding a hearing discussing the licensing of mortgage loan originators and the extension of the Massachusetts State Community Investment Act law to non-bank mortgage lenders. We recognize that there are regulatory weaknesses in our current system of both State and Federal supervision. It is important that we debate and discuss these weaknesses. However, we need to move towards finding common solutions. Ultimately, successful regulation of the mortgage industry requires enhanced coordination among the States and both State and Federal regulators. Improved coordination and communication will increase accountability among mortgage brokers and lenders and provide consistency across the industry to the benefit of the borrower. For example, CSBS would like to work with our Federal counterparts to encourage our supervised entities to reach out to those consumers whose adjustable rate mortgages are scheduled to reset this year.

Thank you again for your invitation to testify today and for the subcommittee's interest in improving our mortgage market system. I look forward to your questions.

[The prepared statement of Mr. Antonakes can be found on page 244 of the appendix.]

Chairwoman MALONEY. Okay, without objection, the written statements of all of the witnesses will be made part of the record, and I thank all of you for your testimony and insights.

Chairman Bernanke and Roger Cull have agreed that the Federal Reserve has broad powers under HOEPA to regulate unfair and deceptive practices for all lenders. I would like to ask all of the panelists, should the Fed use those rulemaking powers to extend this guidance to the entire market? I know that Chairwoman Bair testified in support of such of an action, but I would like to hear from each of you for your particular view on this question. Would you like to start, Chairman Bair?

Ms. BAIR. Yes, we would defer to the Fed and the decision they make, and I understand they have it under review, but we would strongly support them if they did decide to use those authorities.

Chairwoman MALONEY. Okay. Director Reich?

Mr. REICH. I, too, would be supportive of the Fed taking a look at HOEPA to determine if it can be expanded in a way that would not result in a credit crunch to worthy borrowers.

Chairwoman MALONEY. Chairwoman Johnson?

Ms. JOHNSON. Uniformities would certainly have its advantages and so it would certainly be something we would support. It is not

really my area; we regulate in the credit union area, but seemingly the uniformity would be beneficial.

Chairwoman MALONEY. Mr. Rushton?

Mr. RUSHTON. The OCC would certainly support and contribute to the effort by the Fed if they choose to go in that direction. I think, as with the guidance that we have issued in this area, the tricky part is the writing of rules that weed out the predatory and abusive loans without restricting legitimate credit to creditworthy borrowers. But we would support their efforts.

Chairwoman MALONEY. Okay, Ms. Braunstein?

Ms. BRAUNSTEIN. Yes, as I said in my testimony, we do plan to look at our authority under that statute and to look for opportunities to utilize that authority which would cover all lenders. However, as some of the other panelists have alluded to, there are some issues, and it is not an easy process. We need to make sure that whatever rules are written are well-calibrated and are very thoughtful and are done in such a way to, as Mr. Rushton just said, to take care of the bad acts but not overly constrict the markets because we do not want to end up with a situation where people cannot get responsible loans.

There are some dangers under HOEPA, and we are going to look at that. I am not saying they would stop us, but there are some things to keep in mind. One is that HOEPA does carry with it the way for people to file private lawsuits so that dictates even more that we have to be careful about what we write because it is not a matter of the banks being sued that concerns us as much as if there is a threat of lawsuits taking place. And HOEPA also carries with it assignee liability, which means anybody who touches a loan could potentially be sued, that could end up cutting off constraining credit because what you may find if there is not a clear, bright line drawn in any rule that is written, the lenders may get nervous and decide it is not worth doing that kind of credit at all and that would be true of secondary market participants, securities, all along the line because of the assignee liability.

So we are going to be looking, as I say, at this authority. We think that it is definitely worth looking at, and we will try to figure out a way to deal with this but it is not an easy undertaking.

Chairwoman MALONEY. But don't you think the guidance strikes the right balance now?

Ms. BRAUNSTEIN. I think for guidance, the benefits of doing guidance is that it is not enforceable, people cannot sue on the basis of guidance, and guidance is a tool that can be done very flexibly. And the guidance we try to write is principles based so that it would apply to more—because the other problem is the industry is very innovative and creative, as we have seen over the years, and they are constantly coming up with new and evolving products. If we craft things that are too narrow in scope and apply only to specific products, then the industry comes up with something else, so it is a matter of trying to craft something that is broad enough to take care of the bad actions but not overly constrict credit. We will certainly be looking at what is in the guidance to see if some of that can be moved into rules, but I think that is going to take some analysis and study on our part and a lot of conversations with industry and the consumer side and the other regulators.

Chairwoman MALONEY. But don't you think that loans barred by the guidance should not be made, simply put it merely says people who cannot afford the loan should not take out the loan, don't you think that those—

Ms. BRAUNSTEIN. Well, I think a basic tenet of lending is that borrowers should have the capacity to repay. The problem with crafting that into rule, that could end up banning all asset-based lending. There are some cases where asset-based lending may not be a bad thing for certain income levels.

Chairwoman MALONEY. But then the guidance takes in mitigating factors.

Ms. BRAUNSTEIN. Yes, that is true and these are the kinds of things we will be looking at.

Chairwoman MALONEY. When do you expect to come forward with your decision? What is the timetable?

Ms. BRAUNSTEIN. We have started our review of Truth in Lending. We have held hearings; this summer we held hearings all around the country to gather information on this. We are going through that information. We are doing a number of other things. I do not have an exact timetable to give you. We are proceeding and we are being thoughtful about it, and I cannot give you an exact end time.

Chairwoman MALONEY. And the guidance requires ability to repay at the fully indexed rate, is that not a good principle for the entire market?

Ms. BRAUNSTEIN. Basically, I think that is true, but again we are going to have to look at and study these underwriting practices to make sure that—if we codify that in a regulation, it is different than putting in guidance, we just want to make sure that we do not end up constraining responsible credit.

Chairwoman MALONEY. Commissioner Antonakes, and then my time is up.

Mr. ANTONAKES. Certainly, I would personally welcome such an approach, and we would hope that we could work closely with the Fed to best coordinate supervisory as well as enforcement efforts.

Chairwoman MALONEY. Thank you, and I now recognize the ranking member, Mr. Gillmor from Ohio.

Mr. GILLMOR. Thank you, Madam Chairwoman. You have all been in the industry for a long time, and you have seen the up's and down's in the economy. Right now we have, by every objective standard, a very good economy. We have had continual expansion, and unemployment is low, but these are good times. I want you to give me a little projection of what you think will happen if we do not have good times? For example, leading indicators declined in March, that is the third consecutive month leading indicators have gone down, and that is the first time that has happened since the recession of 2001. And you also have a lot of adjustable rate mortgages that are going to be resetting later this year, or resetting next year, so my question is, considering the great increase in foreclosures and delinquencies we already have, what is your assessment of what happens if we do go into a recession? If I could just get a quick response from each of you. Chairman Bair?

Ms. BAIR. Well, our economists have done a lot, there is a strong correlation between delinquencies and defaults in these subprime

hybrid ARMs and what is going on with home price appreciation or depreciation, as the case may be. Certainly you have seen some problems in Ohio, so they are definitely connected. At this point, we think the problems in subprime are contained to subprime. We do not see a lot of spillover, unless something unexpected happens. Obviously, we are monitoring it closely, but we do not see any broader implications at this point.

Mr. REICH. I am going to agree with Chairman Bair. I think that so far the problems have been limited to the subprime market. I was looking at statistics on past dues on various types, the prime past dues continue to be very, very low but not in the subprime market and the big question is, will there be a contagion or spillover effect if the economic situation in general deteriorates, if there are losses of jobs throughout the economy? But at the moment, we are not expecting a contagion effect to spill over into other areas of the economy.

Mr. GILLMOR. Chairman Johnson?

Ms. JOHNSON. We believe that our proactive examination process and our guidance that was issued early has helped prevent a large number of these types of loans in the first place. Our delinquency rate is very, very low and our foreclosure rate currently is less than one-tenth of a percent so that could be a slight increase potentially, but we think it is very, very small.

Mr. RUSHTON. The OCC agrees entirely with our colleagues.

Mr. GILLMOR. So we are okay, all right.

Ms. BRAUNSTEIN. Yes, Congressman, I could attempt to answer that question, but I am not an economist, and there are a couple of hundred economists back at my organization who would probably take my head off if I attempted to answer that, so I think I will pass on that. I do know that we are closely monitoring the situation and that there is still some uncertainty about the wider effects of this, but I am not the person to address that.

Mr. GILLMOR. Ms. Braunstein, let me remind you what Harry Truman said. Maybe you will give more direct answers to me than the economists. He said that he always wanted to have a one-armed economist because they all said, "On the other hand."

[Laughter]

Mr. ANTONAKES. Congressman, I would only add that our concerns have focused on the fact that I believe what you alluded to, that the recent foreclosures have not been tied as closely to the traditional reasons for foreclosure, job loss, death, or illness of a spouse. And certainly it appears to be more driven from the current rate market as well as a decline in housing values. And if you had additional factors challenging homeowners, then I think the situation within the subprime market could get worse. So I think that speaks of our need to be aggressively addressing these issues now.

Mr. GILLMOR. Thank you very much, Madam Chairman. My time has expired. I thank the panel.

Chairwoman MALONEY. The Chair yields 1 minute to Mr. Hinojosa for a unanimous consent request.

Mr. HINOJOSA. Thank you, Chairwoman Maloney. I ask unanimous consent that a predatory lending financial literacy brochure produced by the Center for Responsible Lending and the National Association of Realtors, which I hold in my hands, be entered into

today's hearing record as well as a statement by the National Association of Realtors on the same subject, which would be very helpful to our hearing today.

Chairwoman MALONEY. I thank the gentleman, and I now yield to Mr. Mel Watt from North Carolina, who has been a leader on this issue.

Mr. WATT. Thank you, Madam Chairwoman, and I thank the Chair for convening this hearing, which I think is probably the first step toward—this term of Congress—toward the possibility of a predatory lending bill and it is that interplay that I want to explore a little bit because you have issued some guidance. I assume that guidance applies to—who does the guidance apply to? Does it apply to everybody? Does it apply to just the people under the jurisdiction of—

Ms. BRAUNSTEIN. It applies to the depository institutions that we all supervise plus their subsidiaries and that includes the subsidiaries of bank holding companies.

Mr. WATT. All right, how do we get it applied to State regulated institutions?

Mr. ANTONAKES. At this point, Congressman, 29 States and the District of Columbia have also adopted the guidance as well. My office, we actually adopted it as regulation.

Mr. WATT. If you have adopted—so this guidance now applies to everybody, traditional lenders and subprime lenders, right?

Mr. ANTONAKES. We have other States that—

Mr. WATT. Either it does or it does not.

Mr. ANTONAKES. In my State, in Massachusetts, it applies to every type of lender. We are working with other States to ensure that they adopt the guidance, as well. And we expect that in the short term all 50 States will adopt the guidance so it does apply to everyone.

Mr. WATT. Okay, and from this step, the guidance, you are moving, Ms. Braunstein, towards some regulations, is that where you are headed or what are these hearings and things that you are—what is it that you are contemplating doing in the future?

Ms. BRAUNSTEIN. Yes, it is not really related to the guidance per se, but we were undergoing—before the guidance issue came up, we were looking at our rules under the Truth in Lending Act.

Mr. WATT. And where is that headed?

Ms. BRAUNSTEIN. We are revising that.

Mr. WATT. That is what I am trying to find out.

Ms. BRAUNSTEIN. It is heading for a major revision of those rules in regards to closed-end credit, which would include mortgages. That includes looking at mortgage disclosures and making sure that consumers have the information they need for transactions as well as, as I mentioned today, we will be looking at our authority under the HOEPA portion of Truth in Lending and whether or not there are practices that are unfair and deceptive that we can write rules on.

Mr. WATT. Okay, and those rules would be beyond this guidance that you are talking about or would it be guidance—would it be regulations or guidance?

Ms. BRAUNSTEIN. No, those would be regulations.

Mr. WATT. Okay.

Ms. BRAUNSTEIN. And HOEPA and the Truth in Lending Act apply to all lenders regardless of whether they are depository institutions or not.

Mr. WATT. The question I am trying to get to is, is any of this going to alleviate the necessity of a Federal predatory lending law?

Ms. BRAUNSTEIN. I think that is a decision that the Congress will have to make.

Mr. WATT. Okay. And one of the impediments to passage of any kind of predatory lending legislation last year was the debate about whether it ought to be a Federal preemptive standard or whether it ought to be a floor, which would leave States to innovate and do what they are doing already. I assume I know what the State position on that would be, or do I know what the State position would be, either you support a Federal preemptive standard or you do not?

Mr. ANTONAKES. Well, in the case of my State of Massachusetts—

Mr. WATT. I cannot get a yes or no answer out of you all, can I? We have 5 minutes, I am trying to get to—either you support a Federal preemptive standard or you don't.

Mr. ANTONAKES. I would support one as long as it did not water down existing State rules and allow for State enforcement.

Mr. WATT. So you would just wipe out a Federal preemptive standard even if it was lower than Massachusetts' standard?

Mr. ANTONAKES. No, I would support a Federal law if standards were set appropriately high.

Mr. WATT. What if it lowered California's standard or North Carolina's standard but raised everybody else's standard, would you support it or not?

Mr. ANTONAKES. I am in a position where our standards in Massachusetts are fairly high so I would come at it from that perspective.

Mr. WATT. Are you here speaking on behalf of an organization? Would your organization support a Federal preemptive standard that lowered any State standard that is already in existence?

Mr. ANTONAKES. That is something we would have to discuss within our organization.

Mr. WATT. So you do not have a position, that is what you are saying?

Mr. ANTONAKES. I do not believe we have taken a formal position on that issue.

Mr. WATT. All right, my time is up. You all have rope a doped me for 5 minutes now and nobody has given me an answer to anything. I do not know why you all come over here to testify if you will not take a position on anything. I yield back, Madam Chairwoman.

Chairwoman MALONEY. I thank the gentleman, and I yield 5 minutes to the full committee ranking member, Mr. Bachus from Alabama.

Mr. BACHUS. Thank you. Actually, I thought that he did take a position, but it may not have been the position that the member liked. Let me follow up by saying that—

Mr. WATT. If you do not have a position, that is a position, I guess.

Mr. BACHUS. I hope that is not taking my time. Could my time start again?

Mr. WATT. I ask unanimous consent to give the gentleman back whatever time I took from him.

Mr. BACHUS. Thank you. I will say that the gentleman from North Carolina and I did work well together last year trying to resolve our differences, but the legislation I offered last year was the North Carolina legislation, which is considered a very strong standard. It also gave the attorneys general of the States the right to enforce, which you said was important to the State of Massachusetts. It also gave an individual right of action. Let me ask this, we have now Federal guidance in place and are moving towards regulation. We have 29 States that have adopted the Federal guidance. We obviously have 21 States that have not—I do not know how many of those States have a tough State standard, but I would ask the committee, what are some of the gaps in regulation as they exist today? And let me propose one of them and maybe just ask you about this one, most mortgage brokers are honest people, and I think they do a very good job for their clients but we have bad actors and we have all heard of cases of one broker who made $2- to $300 bad loans, loans that should not have been made, sometimes defrauded the institutions, what do you think about national licensing and registration? I will just start with Ms. Bair.

Ms. BAIR. Well, I think CSBS and the States are moving forward with a State-based national licensing regime which would not require Federal intervention. I think a significant Federal role in regulating mortgage brokers—

Mr. BACHUS. Do what now?

Ms. BAIR. I think a significant Federal role in supervising mortgage brokers, if that is what you are suggesting—

Mr. BACHUS. Yes.

Ms. BAIR.I think that would be difficult and challenging. There are State apparatuses in place for regulating the loan originators as well as banks whom we all regulate.

Mr. BACHUS. You have the mortgage brokers and then you have the loan originators who work for the national institutions.

Ms. BAIR. Right, right.

Mr. BACHUS. And they are regulated.

Ms. BAIR. But you can manage—you can regulate third party relationships. For instance, the banks that we regulate, we regulate the third party relationships—

Mr. BACHUS. What about a national registration or national licensing?

Ms. BAIR. I would defer to Steve. I think that the States are already putting together a national registry and that they may be on that track at a State-based level.

Mr. BACHUS. Okay.

Mr. ANTONAKES. Yes, we have worked for 3 years on creating a national database, ensuring that all entities licensed by the States are entered into this database and we have common sharing of information. We believe it will significantly improve supervision over mortgage brokers. I would also add that just as the States have a duty to supervise the conduct of the mortgage brokers, the entities doing business, including banks that have outsourced their

subprime lending to brokers, have a duty also to supervise that relationship between the banks and the mortgage brokers as well. It seems to me that a far better method of coordinated examination would include a national bank being supervised by their national bank regulator, and also looking at the broker network in tandem with States doing simultaneous examinations of those brokers, so we could determine from the bank regulator's perspective whether the controls are in place and from the State perspective, ensuring that appropriate business practices by the brokers are being adhered to. I think marshaling our resources and working together would provide a far better system of supervision.

Mr. BACHUS. My thought is that we do need a national licensing or registration of brokers. As to how it is enforced, I am not sure. But I would like any proposals that you all have because I think that is a gap in the present system because, as you said, you have national institutions that are now farming out their work to people outside the bank.

Mr. ANTONAKES. But, again, we believe our system will capture that information and will result in a far better supervisory process for the brokers as well as the lenders that are supervised—

Mr. BACHUS. Well, it will on institutions but how about those States which—now, do you require licensing or registration of all brokers?

Mr. ANTONAKES. We require licensing of all non-bank mortgage lenders and mortgage brokers and the majority of States require similar standards and the system we believe will substantially improve coordination among the States and information sharing for the States, the vast majority of States that license lenders and brokers as well.

Mr. BACHUS. How are these brokers getting away with moving from State to State and continuing to make—there has been some documentation on some of them making as many as a thousand fraudulent loans in three or four States?

Mr. ANTONAKES. I think the database will resolve that issue because of common information sharing, access to Federal criminal databases, the form shopping which exists and which a company gets into trouble in one jurisdiction, changes the name, creates a straw, that type of opportunity is going to be gone once the database is up and running in less than 9 months.

Mr. BACHUS. Let me ask one follow-up question.

Chairwoman MALONEY. You have 30 additional seconds.

Mr. BACHUS. We talked about loans and defaulting loans, what about lending to homebuilders, is that jeopardized? It is a very important industry and obviously as homebuilders experience problem—have you seen a pull back in the amounts of loans to homebuilders?

Mr. REICH. I think homebuilders who have built speculative homes have certainly curtailed their activities and our re-trenching in certain parts of the country where supplies of homes have built up, so I am aware of and have heard in a number of parts of the country that homebuilders are indeed re-trenching.

Mr. BACHUS. Are there defaulting loans from the banks, institutions—having delinquencies in loans to homebuilders?

Mr. REICH. With one exception, in the State of Florida there was an institution that likely will result in some losses to that institution because of an over-build situation and some irregularities, which also took place. But on a broader basis, I am not aware of losses occurring in institutions because of re-trenching among homebuilders.

Chairwoman MALONEY. The gentleman's time has expired. Mr. Gutierrez of Illinois.

Mr. GUTIERREZ. Thank you so much. I would like to first just talk a moment about the overall banking industry and financial services industry because it seems to me that a lot of this is about credit and who gets credit in the United States of America. I am lucky to be 53 years old, so I remember when getting a Montgomery Ward's card at 18 percent was hard to get, and then getting a J.C. Penney card. When I got my first MasterCard, it was like 150 bucks and they really checked to make sure. Now my college daughter gets invitations every week to get credit.

So having a conversation about what is happening in the subprime without having a conversation about what is happening overall in the United States as it refers to how we get credit in this country is really doing a disservice to the whole issue. And I would like to say that, Madam Chairwoman, I am so happy you called this hearing because we have the Comptroller of the Currency who does not think that the gentleman from Massachusetts should be able to regulate if he makes a decision and he makes a ruling at the OCC, he thinks he should preempt him. So it is very interesting to watch both of them sit at the same table as though they are both friends and allies of the same people but I do not believe they are allies and friends of the same people.

I think you should be working together not at cross battle from one another. And I think that that is a serious job and so as we look at this issue, we should see what the OCC is doing in terms of trying to preempt because I believe, as many of my colleagues on the other side of the aisle, that many of the best things that happen in government happen at the local level. But if our State attorneys general cannot take actions, and I have spoken to my attorney general, they cannot lock anybody up for doing things that are just as fraudulent as the guys at Tyco and Enron have done in the subprime industry and in the mortgage industry. I have seen examples of it.

You all in that panel, if you have not seen examples of things people should have gone to jail for, then I do not know what you have been doing so I am going to assume that you know much more than I do and have seen the situations much more than I do. So I would just like to say that CitiBank went to CitiGroup and CitiFinancial, they are in the subprime industry, so as all levels of regulation, you should look at what it is they are doing and how it is that they are doing this because they are part of the problem.

I heard some people say we do not want to constrain credit, well, if we do not constrain credit to those who are either not worthy of the credit because they do not have the ability to pay and they know they do not have the ability to pay going in, that is why in great measure we have a subprime industry. There should be considerations. That is why my earlier statement, when I got my first

mortgage back in 1981, I remember bringing all the documentation to the banker. I knew that banker. He knew who I was. He checked me out.

Now we are issuing loans, I buy a piece of land and I build a house, and we speculate on what it is going to be worth later on. Somebody is going to pay the consequences of this subprime industry, 20 percent of the loans. So I want to thank the gentleman, Mr. Watt, for bringing things up.

I want to read something that was put into the record but I want to read it again from the Honorable Sheila Bair. It says, "We understand FRB is in the midst of reviewing the regulations that implement HOEPA. The FDIC would strongly support the FRB should it decide to make greater use of its authorities provided by HOEPA to address predatory practices. Many abuses might be more effectively addressed by regulation rather than statute, especially in the areas as misleading marketing in which the manner and types of abuse change." I suggest you do it and that you work together and that that is what you are, you are all in public service as we are and that we not have to have a hearing so that you can communicate with one another about these issues.

I would like to ask one question of Ms. Bair following up on Mr. Watt. In your testimony, you suggest one option for Congress is to articulate a set of anti-predatory lending standards through legislation. One of the issues we wrestle with up here is preempting the States because, as you acknowledge in your testimony, the States have proven to be innovators when it comes to consumer protection issues regarding Federal legislation. Do you think Congress should establish a floor for protections by establishing a set of minimum standards or should we just preempt the States and implement a national standard?

Ms. BAIR. If you are simply establishing a floor, I do not think that you want to preempt additional State protections above that, no, I do not think you should do that. There could be another approach, you could try a more prescriptive, very strong standard and there might be justification for preemption if you were sure that you were raising the bar, not lowering it. But I think the whole point of this is to increase broad protections, not decrease them, so unless you were confident you were doing that, I would recommend against preempting.

Mr. GUTIERREZ. Thank you.

Mr. WATT. Madam Chairwoman, could I ask unanimous consent to get a response to that question from the other panelists?

Chairwoman MALONEY. So granted.

Mr. REICH. I would agree with Chairman Bair; I think enacting a standard with a low bar would not be a productive act for Congress to undertake.

Ms. JOHNSON. I would agree that in that setting a low bar would be an exercise in futility. It is not going to get to the heart of the problem in protecting the consumer.

Mr. GUTIERREZ. Madam Chairwoman? Should we set standards?

Chairwoman MALONEY. Let the other witnesses respond. Mr. Rushton?

Mr. RUSHTON. We would argue against a low bar, as well.

Mr. WATT. Madam Chairwoman, I hate to interrupt him but they are not answering the question that has been asked. The question is, should there be a Federal preemptive standard, whether it is a low bar or a high bar, should there be a Federal preemptive standard? That is the question.

Chairwoman MALONEY. Okay, then let's go back to Ms. Johnson, do you think there should be a Federal preemptive standard?

Ms. JOHNSON. I have to be honest with you, it is not an issue that we have had a hearty discussion about at the agency. We do not have broad preemptive—we do not do a broad preemptive power right now and so I would really have to study it before giving an answer.

Chairwoman MALONEY. Okay, Mr. Rushton?

Mr. RUSHTON. The OCC has a fairly robust anti-predatory lending standard now. We would certainly support a Federal standard so long as it did not dilute ours. We are hopeful that this guidance that we have proposed, along with the natural correction that is occurring in the market today, would serve the purpose of stemming these abuses. But if it does not, then we would certainly support the Congress if it decided to set a national standard.

Chairwoman MALONEY. Ms. Braunstein?

Ms. BRAUNSTEIN. The Board has not taken a position on a Federal preemptive standard at this time.

Mr. ANTONAKES. We could support a Federal preemption standard again as long as the standard was set high enough and allowed for State enforcement.

Chairwoman MALONEY. The Chair recognizes Judy Biggert of Illinois for 5 minutes.

Mrs. BIGGERT. Thank you, Madam Chairwoman. We are having a lot of discussion in Illinois, particularly in the Chicago area, about this issue. I think the papers describe one woman who received a mortgage for $3,800 a month while she only brought in $2,600 a month. So obviously before the mortgage was even consummated, she was behind in the payments, on the promise by the broker that the payments would be lowered as she went along. Obviously, there was a foreclosure.

One recent law in Illinois was put in that said that in certain zip codes in Cook County, there would be mandatory counseling on mortgages if your credit score was below a certain level. And everything, I think, has unintended consequences. What happened there was that in the area they were worried about racism, that was something brought up. And they were also worried that lenders were leaving those zip codes and going other places. So the law is now out for public comment in all of Cook County, which surrounds Chicago, there would be mandatory counseling for everyone wanted a non-traditional mortgage, regardless of their credit score, that they would have to go to mandatory counseling.

Now, I believe in financial literacy, but I think that this is carrying things to an extreme, for anyone who ever wants a non-traditional mortgage. And in the zip codes there had been a high percentage of foreclosures and a large percentage of high-risk mortgages that were applied for. So I would just like to ask two questions. One, what would you think of such an idea? And, two, what should a lender do when there, when they know that there is going

to be a foreclosure and somebody is in trouble and a lot of these will not refinance? Let's start with you, Chairman Bair.

Ms. BAIR. Well, I am not sure, you mean my view on the idea regarding counseling for non-traditional mortgages?

Mrs. BIGGERT. Yes.

Ms. BAIR. I think that the lender needs to have the obligation to make a determination that the borrower has the capacity to repay, and I think if you have that kind of good underwriting, a lot of these other problems go away and it does not sound like that was done in the case of your constituent. I think we need to be very careful when we start saying that subprime loans will have certain requirements and not prime loans because I think you do have a potentially discriminatory impact, and I think that is to be avoided. A lot of these products are very complex, no matter how much financial education, and a lot of typical homeowners are not going to understand them. That is why I think the lenders who are offering these products need to have the onus on them to qualify the buyer so that they have a product that they can afford.

Mrs. BIGGERT. Would anybody else like to address that issue?

Mr. REICH. Well, I would certainly say that I think the notion of having counseling available is excellent but mandating it would be something that I would be uncomfortable with. With regard to foreclosures, as you mentioned near the end of your remarks, that the impact of foreclosures and what can financial institutions do, we have been encouraging our institutions, and I think to some extent perhaps all of us at the table have been encouraging our institutions to work with borrowers to try to prevent the foreclosure process through extending payments, re-writing the obligations in a satisfactory underwritten matter, similar to as we did following Katrina with our institutions in Louisiana and Mississippi, we encouraged their institutions to be understanding and proactive in trying to help people resolve their problems and that is what we are trying to do today.

Mrs. BIGGERT. Thank you.

Ms. JOHNSON. I would like to add that the counseling is a big part of the educational process for many of the credit unions. They are working with NeighborWorks America and with other organizations and groups out there where counseling actually is a part of the process. Understanding that stack of paperwork before signing on the dotted line is important and if the consumer is educated on the front-end, exactly knowing how those payments may have an opportunity should the interest rates rise, etc., will make a better consumer and it is good for the institution as well. So I do not know as far as mandating it, but I would certainly heavily encourage it.

Mrs. BIGGERT. Thank you.

Chairwoman MALONEY. Carolyn McCarthy of New York?

Mrs. MCCARTHY. I thank you. One of the things that I am curious about, I did not hear it in any of the statements, what is in place to penalize those who abuse the system and basically make these loans to people that they cannot repay? Is there anything in place, are they fined? Some of them are not licensed so they cannot lose their license. It goes back to the other question that one of my

colleagues mentioned, that he just goes to another State. So I am just curious, what is the penalty for making these kind of loans?

Mr. ANTONAKES. In the Commonwealth of Massachusetts over the summer, we did a sting of approximately 100 mortgage brokers that were primarily servicing low- and moderate-income areas, and we focused primarily on the issue of stated income loans and to the extent that we could document evidence that income stated on these loans had been, in fact, inflated. The net result of our examinations where we issued cease and desist orders, essentially shuttering, I believe, nine brokers, putting them out of business, fines were involved, and we have made referrals for appropriate criminal action to our State attorney general who will be looking to follow up.

Mrs. MCCARTHY. What kind of fines?

Mr. ANTONAKES. The fines were in the hundreds of thousands of dollars. The primary issue for us was—

Mrs. MCCARTHY. Did they pay the fines?

Mr. ANTONAKES. We have had some pay the fines and others—

Mrs. MCCARTHY. Some paid?

Mr. ANTONAKES. The ones that we allowed to continue in business under very different structures paid the fines, others were—and those cases involved only a very individual rogue employee versus a systemic issue. The ones with systemic issues are concerned with shutting those companies down and not allowing them to do business any further in the commonwealth and where appropriate we believe we have made referrals to again our State attorney general, who we will hope will prosecute in what we would believe would be a firmer resolution at the end of the day.

Mrs. MCCARTHY. So with Massachusetts particularly, there is absolutely no reason for these brokers who are out there to actually stop, is there? No answers?

Ms. BAIR. We regulate banks but we do have regulations and supervisory guidelines pertaining to the relationship of the bank to the mortgage broker.

Mrs. MCCARTHY. What happens to the big guys?

Ms. BAIR. We bring enforcement actions, we issue cease and desist orders. There can be significant financial penalties as part of our regulatory authorities but we can only indirectly impact mortgage broker activity through the relationship with the bank.

Mrs. MCCARTHY. Over the last 6 years that we have been talking about this issue, would you say that a lot of them have been prosecuted or fined? I know I am still seeing it in my district. I have a very large minority district. I certainly have brought in a lot of the financial institutions to educate my constituents and consumers and that is great. A lot of them, unfortunately, do not come to the meetings to learn about it and to hear about it. I have a group that I work with, the Community Development Institute of Long Island, and basically they look for people who want to buy a home. Certainly they would be those who are not qualified to buy a home but they have to go to school. And my colleague, Ms. Biggert, was talking about it where it is mandatory; this is not mandatory. Well, for them it is mandatory because if you want the loan, you have to go through schooling because one of the things no one ever talks about, some banks do, a lot of them do not, what

are the taxes going to be, what are your utilities going to be? It is one thing to say you have a mortgage there, what is your insurance going to be? You hold those things up and most people, a lot of people would not be able to afford that. Should that not be into the education of the consumer when they are trying to take out a loan?

Ms. BAIR. Well, our guidance specifically requires lenders, when they underwrite the loan, to take into account taxes and insurance as part of the underwriting process. It is not just the principal and interest, it is the taxes and insurance as well. And, yes, I have heard anecdotal reports of situations where that underwriting does not reflect taxes and insurance and you end up with these kind of serial refinancing situations where every time the tax and insurance comes due, you have a situation where the borrower has to refinance.

Just getting back to your original question as well, I would point out that under Unfair and Deceptive Acts and Practices authority under the FTC Act, the FTC can bring actions though they obviously have limited resources. State AGs as well, under State laws prohibiting unfair or deceptive acts or practices, can bring actions addressing the type of conduct that you mentioned.

Mrs. MCCARTHY. I guess what boggles my mind is that, and probably because we sit on this committee, when you look at—on TV, they advertise constantly you can refinance your mortgage for 4.2 percent. I yield back my time.

Chairwoman MALONEY. Patrick McHenry of North Carolina?

Mr. MCHENRY. I thank the chairwoman. I want to thank the panel for being here, as well. Ms. Johnson, at NCUA, in your testimony you said that—you cited some stats on fixed rate and adjustable rate mortgages for credit unions and you said 68 percent of credit unions are for mortgages of some size or some scope. To what extent do credit unions make subprime or non-prime loans?

Ms. JOHNSON. Congressman, thank you, that is a good question. Sixty-one percent of the loans are fixed, that leaves 39 percent adjustable. In our current 5300 Report, we have not been separating out the exotics in the subprime. We have changed that reporting method and starting with this quarterly report, we will now be able to measure that directly.

Mr. MCHENRY. So you do not know?

Ms. JOHNSON. Our educated guess is that it is less than 1 percent. It is very low because the overall numbers for credit unions are very low.

Mr. MCHENRY. But there is no way to know, you do not have any data?

Ms. JOHNSON. We will shortly.

Mr. MCHENRY. But the answer is, no, we have no data. Okay, thank you.

Ms. JOHNSON. But I think it is important—

Mr. MCHENRY. I would suggest to you that perhaps these nontraditional loans, non-prime loans may help serve your mission to help the underserved. Further, Mr. Reich, with OTS, is it true that many of the foreclosures and delinquencies we are seeing are a result of mortgage fraud?

Mr. REICH. It is true that mortgage fraud has become a significant problem, yes.

Mr. MCHENRY. Do you have any statistics?

Mr. REICH. I do not have data, I will be glad to get back to you in writing if we have data available.

Mr. MCHENRY. I would certainly appreciate that. That is what I am trying to get at is what portion of foreclosures and delinquencies are due to actual fraud because that is certainly a problem in the marketplace. And rather than simply blaming the lender, let's also look at the borrower, perhaps they have some burden here as well.

Additionally, we talked about a number of things here today. The OCC, Mr. Rushton, you testified that national banks are about 10 percent of the subprime market, is that correct?

Mr. RUSHTON. Yes, less than 10 percent of the new originations last year came from national banks.

Mr. MCHENRY. Is that based on volume or dollar?

Mr. RUSHTON. Dollar amount.

Mr. MCHENRY. Dollar amount?

Mr. RUSHTON. Yes, sir.

Mr. MCHENRY. Okay, do you have any statistics on actual percentage of originations and numbers?

Mr. RUSHTON. The total dollar amount was about $60 billion in subprime loans, a little bit less than that in Alt-A loans that are below prime but not subprime. Combined, they come out to about 16 or 17 percent of all of the below-prime loans that were made in the system last year.

Mr. MCHENRY. Certainly. Mr. Reich, you also testified that you have seen this economic cycle 6 times, I think that is a fascinating amount of experience you have. And you said 13 percent of the national mortgage debt is within subprime?

Mr. REICH. That is correct.

Mr. MCHENRY. Okay, so what I have been hearing today is dealing with 13 percent of the mortgage market. What I would ask the whole panel, could you say yes or no, is the mortgage marketplace working, meaning supply and demand, is that functionally in the marketplace? What we have it seems now in the mortgage marketplace nationally with record homeownership is that there was a large amount of credit that was available because people were willing to take higher risks with the possibility of return for that risk. And then in reaction to that, with the changing economy, the actual mortgage market is constricting. So if we could just go quickly, I do not have much time left, to simply say whether or not you think it is actually functioning, the mortgage marketplace is actually functioning, just yes or no or perhaps—with my colleague from North Carolina, I realize that many of you will say "maybe" or something long-winded, if I could just get a "yes" or "no" out of you or you could just simply say, "Pass."

Ms. BAIR. I would have to say on a macro-level, yes. But on a micro-level for individual families, no, for a lot of them it has not been working.

Mr. MCHENRY. Mel, I think you are right about the panel. Number two?

Mr. REICH. I would say yes. If I had the opportunity to clarify it, I would say that maybe for 15 percent of the market it is not working as smoothly as it should be.

Ms. JOHNSON. I would say yes. In fact, we encourage credit unions to try to assist their subprime borrowers and make a difference between subprime and predatory lending. A lot of subprime borrowers out there need to be in a home as well and it can be done with proper due diligence.

Mr. RUSHTON. We say yes, and we believe it will correct itself as it has in prior cycles.

Ms. BRAUNSTEIN. I would say yes, but we do have concerns about those areas where it is not working as well as it should be.

Mr. ANTONAKES. Yes, but it can be improved.

Chairwoman MALONEY. The gentleman's time has expired. Mr. Clay of Missouri?

Mr. CLAY. Thank you, Madam Chairwoman. Let me start with Ms. Braunstein. In St. Louis, Missouri, it is predicted that almost 20 percent of all subprime loans will go into foreclosure. This problem that we have in the subprime mortgage industry is catastrophic. This did not happen overnight. The system has numerous fail-safes to detect such happenings and why is it that the Federal Reserve system did not see this coming? Why is it that our other agencies that watch or control banking and commerce did not see this coming? Was the problem one of not seeing a situation or in just not reacting? What happened and who dropped the ball?

Ms. BRAUNSTEIN. Congressman, actually, we did see that there were issues in these markets and we have been issuing guidance on real estate and subprime as far back as the 1990's to try to address the situations as we saw them. This recent phenomena that we are seeing right now, actually the downturn did not come until late 2006 so that is a fairly recent phenomena and as soon as we saw it, we did issue the new proposed guidance for subprime mortgages. So we have been taking actions all along and we have done a number of things with other guidance and regulations to try to address the situation.

Mr. CLAY. Let me go to Mr. Rushton, the Comptroller of the Currency. Ohio, which had the highest foreclosure rate in the Nation at the end of last year, plans to issue $100 million in taxable municipal bonds next month to help homeowners refinance mortgages. Proceeds from the bond issued by the Ohio Housing Financing Agency will finance 1,000 loans with a fixed rate of 6.75 percent. The loans will be limited to homeowners with incomes up to 125 percent of the median income of their county and will take them out of their adjustable rate mortgages, interest-only mortgages, and avail them the opportunity to move into fixed rate mortgages. Is this a solution that can be used on the Federal level? What are the pros and cons of this solution on a nationwide basis? And can this work as an assist with other programs and solutions to avert home foreclosures?

Mr. RUSHTON. What you have described sounds like an excellent solution in terms of a takeout program that will alleviate pressure on the borrowers in trying to find financing that is going to be very difficult for them to get. It is helpful in another very important way in that it gets around all of the restrictions that may apply to some

of these loans that are now in securitizations or subject to other servicing agreements where the holders of the loans have not given any flexibility to work with the borrowers to help them out. Your program would get around that, and it sounds very good based on the parameters you have outlined. In terms of a more omnibus application of it on a Federal level, we would be delighted to work with the subcommittee in exploring that.

Mr. CLAY. Thank you for that response. Let me share with the panel a recent publication from the Sunday St. Louis Post Dispatch with the headline, "Minorities Beware: Home Loans Reflect Bias." And this is a question for anybody who cares to take a stab at it on the panel. A recent study by the Center for Responsible Lending concluded that black borrowers are 3.2 times more likely to receive a higher rate than white borrowers and the disparity decreases when adjusted for differences in credit scores, income, and other risk factors but significant differences remain. After adjusting for such traits, blacks were still 1.6 times more likely to get higher rate subprime loans than whites when purchasing a home and 1.3 times more likely in refinancing, Hispanics too. Tell me how do we address that? What do we do? How do we take the race factor out of home loans? And I am going to ask the next panel who comes forward also, but how would you address the race factor?

Ms. BRAUNSTEIN. One of the things that we are doing, and I think all the agencies do, is we conduct very robust examinations, fair lending examinations, in our institutions. We look closely at the data that comes out and when there are pricing disparities and we use that as an initial screen to go in and gather more information and do very thorough analyses of what lenders are doing in terms of pricing and who the loans are made to. If we find that they are making pricing decisions based on race, we will refer them to the Department of Justice and we have done so. And the problem sometimes is not all these loans—in the statistics you are reading, not all those loans are being made in the depository institutions that are being regulated and having robust fair lending examinations.

Chairwoman MALONEY. The gentleman's time has expired. Mr. Neugebauer of Texas?

Mr. NEUGEBAUER. Thank you, Madam Chairwoman. I kind of relate to what Mr. Reich said, I have been in the real estate business through most of those cycles and have some scars to show from it. One of the things I want to go back to is back in the 1970's when I was in the banking business and originating mortgages, we used—kind of the guidelines were set by the marketplace and that was Freddie Mac, Fannie Mae, FHA, and the PMI companies. In other words, you used their underwriting guidelines and that pretty much set the standard for the markets. And if you made a loan that was kind of outside those guidelines, and I was in the banking business at that particular time, we just knew that we were going to have to hold that loan in our portfolio. And so one of the questions that I have today is as we move down this road I think it is important to make the distinction between subprime lending and predatory lending, those are really two different issues, and we need to be careful here that we are not trying to fix one with the problems that exist in the other. But in your mind today with the

sophistication of our financial markets, the fact that those four entities really do not control as much of the flow of the mortgage lending activity today, do you still think within the marketplace today there are enough market forces that we do not need to really start down the road of mandating what the criteria for mortgages are going to be? And I will start with you, Ms. Bair, and kind of run across the table there.

Ms. BAIR. Well, I think it is a very perceptive question. In securitization, most subprime mortgages are purchased by the so-called private label, the non-agency investors. There is a lot of liquidity these days and there has been an analysis suggesting that has played a role in the depressing of lending standards. When you were in the business, you held that loan in the books, you worried about whether it was going to perform. Now all the stuff can be sold off. We are having a securitization roundtable with OTS and OCC and the FRB on April 16th, and one of the issues we are going to look at is the impact of securitization on underwriting and also going forward how to help people restructure loans so that they can get into a product they can repay and how we work with the investor community to accomplish that.

Mr. NEUGEBAUER. Mr. Reich?

Mr. REICH. I am a little reluctant to see Congress become so prescriptive as to proscribe underwriting standards for various types of loans. I feel the same way frankly about regulatory agencies becoming overly prescriptive. That takes away the creativity for bankers to do what they do best in devising solutions for particular borrowers.

Mr. NEUGEBAUER. Thank you. Ms. Johnson?

Ms. JOHNSON. Credit unions do use the secondary market, however, many of them retain the servicing, etc. However, credit unions are restricted in their investment opportunities and are restricted to highly rated securities so purchasing those is different for credit unions.

Mr. NEUGEBAUER. Okay, Mr. Rushton?

Mr. RUSHTON. We would be a little wary about endorsing underwriting standards by the government, frankly, because it would be difficult to apply to the entities that have become preeminent in recent years. The reason that the GSEs have declined in importance is because the investment banks, including Wall Street firms, have been able to do this business themselves, and they are selling to investors who do not have the same interest at heart in terms of consumer protection and other risk considerations as banks do. If a standard could be written that could be applied to the Wall Street firms and other players equally, then we would probably support it, but we would be wary of doing that because you are essentially substituting Federal judgment for that of the willing borrower and lender and funder of the credit.

Mr. NEUGEBAUER. Ms. Braunstein?

Ms. BRAUNSTEIN. Yes, we would also be concerned about dictating underwriting standards. As I mentioned even in regards to using our HOEPA authority, we want to be very careful that whatever is done is not an overreaction to a specific situation and that it does not constrain responsible lending that is out there in the market.

Mr. NEUGEBAUER. Mr. Antonakes?

Mr. ANTONAKES. Well, the Wall Street firms and securitization have resulted in a great deal of additional credit being made available but we cannot ignore the fact that they have also created the desire for a very high-risk product and the market is adjusting, but I would say a little too late and I do believe that the guidelines, as issued by the Federal regulators and the States, are essential in ensuring that tenets of sound underwriting are adhered to at all times.

Mr. NEUGEBAUER. I want to go back to Ms. Bair just for a quick—one of the things I was noticing that as this subprime thing started kind of unraveling, a lot of the repurchase agreements started being put back, and I guess from a regulatory standpoint, have you all been kind of reviewing not only the ability of the repurchasing folks, when banks or financial institutions are holding those for investment purposes?

Ms. BAIR. There have been a lot of put-backs, and I think that is another area of concern. The representations and warranties part of these securitization agreements can sometimes be quite broad in enabling the securitization program to put the loans back and that is obviously a problem for us because they have not held capital. We have assumed those assets have gone. So, yes, it is another thing that we are looking at. We are concerned about it, we are tracking it, but at this point, I do not think that it presents a fundamental safety and soundness issue for insured institutions. It is certainly something we are very aware of and scrutinizing.

Chairwoman MALONEY. The gentleman's time has expired. Brad Miller of North Carolina, also a leader on this issue.

Mr. MILLER OF NORTH CAROLINA. Thank you, Madam Chairwoman. Mr. Rushton, you testified that the subprime mortgage lending market had made homeownership much more available, that many people could get into a first home as a result of subprime lending, which I do not doubt is correct, but the Mortgage Banker's Association's estimate is at 55 percent of subprime loans are refinances and only 45 percent are for the money to purchase homes with, is that correct?

Mr. RUSHTON. I do not have any reason to disagree with the MBA's numbers on that.

Mr. MILLER OF NORTH CAROLINA. Okay, and their estimate is about one quarter of subprime loans to purchase a home or for first time purchases, does that sound correct?

Mr. RUSHTON. Yes, sir.

Mr. MILLER OF NORTH CAROLINA. So it is about 11 percent of subprime mortgage loans are actually to purchase a first time—

Mr. RUSHTON. If that is what the math comes out to.

Mr. MILLER OF NORTH CAROLINA. Okay. Do we have any data on the defaults and how much of the defaults are refinances, how many that are mortgages to purchase a home with, and particularly a first time?

Mr. RUSHTON. That data may be available, sir, but I do not have it with me today. We would be glad to try to supply that to you.

Mr. MILLER OF NORTH CAROLINA. Okay, where is it available?

Mr. RUSHTON. Back at our office.

Mr. MILLER OF NORTH CAROLINA. Okay, I would be very interested in seeing that.

Mr. RUSHTON. Okay.

Mr. MILLER OF NORTH CAROLINA. And there has been a lot of assumption in the reporting on this question in the last couple of months that the defaults were mainly folks who were just spendthrifts who were buying more house than they could afford and could not pay their mortgages. Do you know if there was any information that shows that is in fact what is happening or people who got in trouble, the usual kinds—death, divorce, job loss, necessary home repairs?

Mr. RUSHTON. The precise reason that a borrower develops financial problems is not something that we track, but we can try to run that down.

Mr. MILLER OF NORTH CAROLINA. Okay. Just to pick on somebody different, Ms. Bair, Mr. Clay asked about the OMDA data which shows that about 17 percent of white families who are borrowing for mortgages, we are not talking about all borrowing, we are talking about mortgage borrowing, which is something that is usually more restricted to the middle class or in subprime loans but almost half of Latinos and more than half of African American families. The Center for Responsible Lending has analyzed that further and found that every other objective criterion went into value assets, income, credit history, everything else, even when that is taken into account, there are still substantial disparities, is that consistent with your own observation?

Ms. BAIR. Yes, we are very concerned about this and have addressed it in the draft subprime guidance that is out for comment now. Some of the lending analyses we have been doing on subprime mortgages that have been securitized, which is most of them, show that there is a big percentage, I think 14 percent, where the FICO score was actually over 700.

Mr. MILLER OF NORTH CAROLINA. Right.

Ms. BAIR. Which leads you to wonder, why is this person in a subprime loan?

Mr. MILLER OF NORTH CAROLINA. But Freddie Mac, I think, estimated a couple of years ago that 25 percent of the subprime mortgages they purchased were from borrowers who qualified for the bond market.

Ms. BAIR. There is a problem that borrowers are not referred up. A lot of lenders just specialize in subprime so if they qualify a person, that is the product that they do instead of referring him to the prime products.

Mr. MILLER OF NORTH CAROLINA. And that is, in fact, something that Ms. Braunstein also raised, so perhaps both of you, one thing that I have heard argued is that African Americans are simply choosing different mortgage products, and I have some difficulty imagining an African American homeowner walking into a financial institution, a lender of any kind, and saying, "Can I get a 2/28 mortgage with a teaser rate that I can qualify for but an adjusted rate I cannot possibly pay and a 4 year prepayment penalty." Do you really think that African Americans are consciously choosing different mortgage products, either or both of you but you can go first, okay?

Ms. BRAUNSTEIN. I do not know that it is a conscious choice. What we heard, in fact, in the hearings that we did over the summer anecdotally and what we have seen in conversations is that there is an enormous amount of push marketing that goes on in minority neighborhoods where the purveyors of these subprime mortgages are very actively involved in marketing and that same level of marketing does not go on by prime lenders.

Mr. MILLER OF NORTH CAROLINA. Ms. Bair?

Ms. BAIR. I was just going to say I think this is a broader problem—minorities more frequently having high-cost products. We have created an Advisory Committee on Economic Inclusion and we are trying to look at this broader issue. We want to understand why banks are not in there more and to what extent we can get mainstream prime bank lenders to do more aggressive marketing and servicing in these communities. I think a lot of this is being driven by the lender, not by the borrower, and we would like to see if we can get banks reaching out more to these neighborhoods.

Chairwoman MALONEY. The gentleman's time has expired. Mr. Price of Georgia.

Mr. PRICE. Thank you, Madam Chairwoman, and I want to thank you also for holding this hearing. It is an important area, one that in my home State of Georgia we have dealt with for a number of years, serving in the State legislature we had some interesting challenges a number of years back, as some of you may recall. I have had some conflicting meetings this morning, and I apologize. I want to thank each of you for coming and I have read significant portions of your testimony, and I appreciate the perspectives that you bring to the table. I do not want to repeat specific questions that were asked, and I am sure they have been and I will review the record for that. But I would like us to step up kind of to the 30,000 foot level, my understanding is that each of you have stipulated here today that you believe that the mortgage banking system is working in our Nation right now and obviously I guess the correlate of that is it is accomplishing some good for the majority of folks who are accessing that system. I think the big question is whether or not the Federal Government has a further role in defining what ought to occur or whether the guidelines in the regulatory apparatus that we have in place right now are capable of correcting whatever ill view we, anybody believes is in place or has occurred over the last couple of years. So my question, and coming from a firm sense of belief that the Federal Government is relatively incapable of being flexible in promoting or providing guidelines for any industry, I would ask each of you just the general question whether or not you believe that the current system we have in place, the regulatory system we have in place, is capable and will in fact correct the system or correct any ills that have been alleged or whether you believe that further action by the Federal Government in this specific area is helpful for our overall system. And if we could start, Mr. Antonakes, at this end and kind of head on down, I would appreciate it.

Mr. ANTONAKES. I do believe the constructure of regulation will appropriately deal with these issues, and I do believe, that being said, that within the States we can coordinate and do a better job, and with the States and the Federal Government we can coordi-

nate and do a better job. I think that will result in even more effective supervision of really every entity involved in the transaction, including the broker, the lender, the funder, and then the securitization process as well.

Ms. BRAUNSTEIN. At this time, we do not see a need to ask Congress for additional authority or additional legislation. We think that what is there now is appropriate and can deal with the situation.

Mr. RUSHTON. We agree. We believe the non-traditional mortgage guidance the agencies issued in October, as well as the subprime guidance that we now have out for comment, uniformly implemented by all regulators, along with the natural operation of the market, is all we need right now. We do not think we need anything else.

Ms. JOHNSON. If you believe that consumers are better off with traditional mortgage products and traditional type loans, there is one area where Congress could facilitate with the credit unions when we are talking about the underserved areas and the minority population in particular. All credit unions are not able to adopt underserved areas, and I think credit unions are a traditional federally-regulated institution that could reach out to this population in particular and help in the subprime are. We encourage with due diligence credit unions to make these types of loans to help people get into homeownership so that is one thing that needs to be or could be changed with the statute.

Mr. REICH. The market is in the process of correcting itself. We have issued guidance for comment, expiring May 7th. Many subprime lenders have exited the business. The liquidity for subprime lending has essentially dried up and so I think largely the market is in the process of correcting itself. Having said that, there are a number—there are probably a number of borrowers who are going through foreclosure who are not going to benefit from the guidance that is proposed.

Mr. PRICE. If I may, that skirts the question a little bit in that the market is correcting itself, but do you—and I do not want to minimize the number of foreclosures out there because for each of those families obviously it is a significant trial. Do you believe that any changes should be put in place to prevent the next cycle that might result?

Mr. REICH. Well, I have expressed some support for Congress to take our guidance on subprime lending and make it a standard that would apply to all lenders beyond insured institutions.

Mr. PRICE. I appreciate that. Madam Chairwoman, may I get one brief comment from Ms. Bair?

Chairwoman MALONEY. The gentleman's time has expired and she has spoken on this already several times.

Mr. PRICE. Thank you.

Chairwoman MALONEY. David Scott of Georgia?

Mr. SCOTT. Thank you very much, Madam Chairwoman. If we look at the situation as we have it now and with a lot of the testimony that is going forward, with the surveys that have come out by Bankrate.com on Monday, and with the fact that I represent the State of Georgia, which has the third highest foreclosure rate, with the fact that within the next 24 months, 2.2 million homeowners

will go into foreclosure and the fact that in addition to that, Mr. Greg McBride, who is the senior financial analyst of Bankrate.com in the survey points up this salient fact, that the greatest concern that we, and I say "we" in the financial service industry have, of which we in the financial service industry are victims of is the complexity, the confusion, the culture, and the language of the financial services area is so confusing that as Bankrate says 40 percent of all the homeowners in America, prime and subprime, do not even know what they have signed. So it says to me with this information that as we move forward on this issue, one of the most important parts of our legislation should be and must be a major offensive on financial literacy and financial education, which to me is the greatest way in which to solve this problem because the major concern is how do we come up with that delicate balance with which we would be able to put forward legislation that is not so overreaching that it will dry up the credit for an underserved population which basically has been aptly described, African Americans, the elderly, the poor, which are targeted. This is a targeted phenomena by people who, some legitimate, some bad actors out there, but there is a predatory lending class of people who target this. So the point I want to say going forward is my hope is that we will make sure this legislation going forward has a major component piece in it that is a serious financial literacy piece that is targeted at African Americans, it is targeted at the community that the predators targeted because if the financial services industry, and especially those dealing with mortgages and real estate, the banking communities, if you do not make sure of this, we may very well have to revert to an overreaching legislative piece. So I want to make this urge that we have it and that we have a toll free number in, that we have human beings at the end of the phone, that we have it structured as an infrastructure within the Treasury Department where we really take it serious, where we put money and resources into the grassroots community, into the AARPs, into the NAACP, into those groups that have the legitimacy, into the church community, where people who are being targeted listen to. And if we get nothing out but one message, before you sign on the dotted line, call this number, talk to somebody because if Bankrate.com is right in its survey, we have a major, major problem of a lack of a financial education and financial literacy for a hugely growing amount of people.

Now with that said, my commercial for financial literacy being said, it concerns me that when Chairman Bernanke, head of the Fed, came before this committee a few weeks ago and was asked about this question, he used some very rarely used strong language from the Fed in regarding any aspect of the economy, he used the words "concern" and "unease," and "very concerned" to describe his thoughts on the subprime lending situation. Now, as head of the central bank, these are words that are used, as I said, sparingly and very often never but do his words of concern and urgency create additional concerns that this subprime meltdown will create broader credit crunch were the subprime problem spread to the prime mortgage industry and even further into corporate credit?

Mr. HENSARLING. I thank the Chair. I think I heard earlier—say something along the lines that our mortgage markets are by and

large working today or at least perhaps roughly 85 percent of the market. Is that a correct assessment of what I heard earlier?

I think at least I heard you, Mr. Reich, say that at least as of now in your opinion with respect to some of the subprime foreclosure issues that are the focus of this hearing, that the market is essentially correcting itself. Is that correct?

Mr. REICH. Well, I indicated that as a result perhaps of the guidance that the regulators have issued, that liquidity has dried up, a number of lenders have exited the business.

Mr. HENSARLING. Which I understand doesn't help you if it's your home that is actually on the list to be foreclosed. I am constantly reminded of an aspect of the Hippocratic oath, and that is, "First, do no harm."

Now for roughly 85 percent of the market it has worked well, and in some respects if the market is beginning to correct itself, I just want to make sure that as a Congress we do no harm, since we all are aware that we have the highest rate of homeownership that we've ever enjoyed in the Nation's history. And at least some of that, I assume, is attributable to subprime lending and creative mortgage products.

I want to ensure that we protect consumers from fraud. I want to ensure that we protect consumers from either misleading or ineffective disclosure, but I'm not really sure I want to protect consumers, an informed consumer, from making a decision that may be a foolish decision because if I circumscribe his opportunities then I'm doing it for everybody else in the Nation.

And I would like to follow up with some comments on the line of questioning from the gentleman from Georgia over here, Mr. Scott. We haven't agreed a lot recently, but we certainly agree on this. And that is a lot of the disclosures that we see in these real estate transactions can be highly misleading using a jargon that many consumers do not understand.

And I myself, my wife and I, closed on a condo here in Northern Virginia 2 years ago, and I signed a dizzying array of disclosure statements, none of which I understood. And believe it or not, I'm an informed lawyer, and if I don't understand it, I'm not sure how anybody else is going to understand it.

So my first question is, to whoever wants to take it, what can we do to make disclosure more effective, and in some cases isn't less more? Whoever would care to take that one, that ball is up in the air.

Ms. BRAUNSTEIN. I'll take the first shot at that. Since we are the rule writers for the Truth in Lending Act, which controls the mortgage disclosures, it's not everything—people often think that everything you get at settlement comes out of Federal disclosure laws, and that's not really true. There are really only a few pieces of paper that are involved with the Federal laws. The rest of it are other things.

But we are engaged in an effort to look at all the mortgage disclosures that are required by the Truth in Lending Act and try to make them more understandable. We agree with you that they are not optimum at this time. We are planning to engage in consumer testing and focus groups. We have gotten away from the idea that used to exist in the olden days which was that lawyers sat around

in a room and developed consumer disclosures which ultimately, at the end of the day, the only people who understood them were other lawyers, and obviously not always even other lawyers.

Mr. HENSARLING. Well, I commend the effort. I think it is a good one, and I think somehow simplicity of disclosure, more effective disclosure, what Mr. Scott was speaking of, more effective consumer financial literacy is at least part of what it's going to take to help remedy this situation.

And I have another question, and that is listening to some people engaged in this debate we seem to be going down—in some respects some people seem to be going down what I consider to be a slippery slope of only having the lender decide on the suitability of a credit product, and that if for some reason the lender chooses the wrong credit product then all of a sudden liability will attach to the lender.

It seems to me that a lot of the major players in the market if that were true would simply become risk adverse and begin to exit this market. And then all of a sudden millions of Americans who would have had homeownership opportunities would be denied those opportunities. Do you agree with that assessment?

And once again the ball is up in the air, since I only have time for one answer, I assume. Ms. Bair?

Ms. BAIR. Well, I think borrowers should have the ability to repay. It's an age old underwriting standard, and banks certainly are very familiar with underwriting to make sure that when you qualify a borrower for a loan, that borrower should have the ability to repay the loan.

I don't support a suitability standard. I think that's a securities concept. I'm not sure it applies. I think it would be confusing and could create a lot of uncertaintly. If we're talking about ability to repay, I think some people confuse the two. I do think we should have an ability to repay standard. That's been around a long time. It's just a commonsense standard.

Mr. HENSARLING. Thank you.

Chairman MALONEY. The gentleman's time has expired. Emanuel Cleaver from Missouri.

Mr. CLEAVER. Thank you, Madam Chairwoman. Can I find out first of all those of you who agree—I'm following up on the questions and comments of my colleagues, Mr. Miller and Mr. Scott. So can I find out those of you who agree that there is in fact marketing of subprime loans in African-American and low-income neighborhoods? Do all of you agree? Is there anyone who does not agree?

What kind of action do you think we should take if we discover that there was advertisement going on in a particular neighborhood for joggers to start running in a particular area of the city and if they were just given an avalanche of information, flyers about jogging in this area and when they jogged in the area they were mugged. Do you think that the free market system should allow us to continue to allow pamphlets to be distributed in this neighborhood about coming to another area where they would be mugged or whether something should be done?

Actually, we're talking about mugging here anyway, financial mugging, so I'm trying to figure out what you think should be done.

Did you understand the question? Did you understand the illustration about passing out leaflets in the neighborhood to get people to come jog in an area and they would be mugged when they get into the area? Is there anybody who doesn't understand it?

Ms. JOHNSON. Congressman, we believe that credit unions can actually do a very responsible job of subprime lending, separating subprime from predatory lending. There's a need for subprime lending. And again I would say that something that would help would be allowing all credit unions to adopt underserved areas so that those consumers would have access to another traditional type of financial institution.

Mr. CLEAVER. Okay. Why do you think the marketing is going on in African-American and low-income neighborhoods?

Ms. BRAUNSTEIN. I think that oftentimes there is a perception that borrowers in those neighborhoods are more vulnerable and that this obviously was a way of generating income on the part of the people doing the marketing—

Mr. CLEAVER. Mugging, mugging.

Ms. BRAUNSTEIN. And I think that there are a couple of ways that we can address that. It's difficult to stop people from marketing in a neighborhood. However I think, as the Congressman from Georgia said, financial education is incredibly important for consumers, and we have also tried to encourage prime lenders to be more assertive in those neighborhoods.

Mr. CLEAVER. Is there anyone who disagrees that there's financial mugging going on directed toward particular neighborhoods?

Mr. REICH. I don't doubt that it may be occurring, and to the extent that it is a result of actions by insured institutions who are supervised by the regulatory agencies sitting at this table it will stop as a result of the proposed guidance, which is out, when that guidance becomes effective, when institutions are forced to make their loans based upon the abilities, the individual's ability to repay the loan.

Mr. CLEAVER. Would that include prepayment penalties that—

Mr. REICH. We have addressed the subject of prepayment penalties in the guidance also.

Mr. CLEAVER. Thank you, Madam Chairwoman.

Chairman MALONEY. Congressman Campbell from California.

Mr. CAMPBELL. Thank you, Madam Chairwoman. I've listened to a lot of discussion about the difference between predatory and subprime, but what I wanted to talk about a little bit is the differences between predatory and poor predatory practices and poor underwriting.

The conditions which have caused this hearing to occur today, my perception is that what has been going on is much more attributed to just flat poor underwriting than it is to predatory practices. And part of the reason I would say that, and then I'll ask you all to comment on whether you agree with that or disagree with that, one of the things we've heard a lot about is we have a number of these loans out here where the first payment hasn't been made.

Well, if the first payment hasn't been made, that's really bad underwriting but almost certainly not predatory. In a lot of cases there's bad underwriting but the people have a good interest rate and everything else. They just—nobody should have made them a

loan because they just weren't in a position to pay it back. So do you agree that that's really where the issues are?

I'm not suggesting there's no predator. I mean obviously I'm not suggesting that. I'm just suggesting that what there's been a lot of lately that perhaps has occurred—gotten to the problem that we're in.

Ms. BRAUNSTEIN. I think it's been a combination of lax underwriting, and there also are instances, I'm sure, of predatory lending. I think it would be very difficult to separate and quantify how much of which was going on.

Mr. CAMPBELL. But they are very distinctly different practices. I mean arguably predatory, the lender is taking advantage of a potential borrower and making a lot of money on them. With bad underwriting the lender is going to lose money because—if they make too many loans that people can't pay back.

Ms. BRAUNSTEIN. Well, no. I think there's a lot more overlap than that because even with lax underwriting if there were initial fees up front the lender still is going to make something on the front end. So I think there's a lot more overlap between predatory and just bad underwriting, and there's probably some of both in this market.

And as I said, I think it would be very difficult to separate it.

Mr. CAMPBELL. Anybody else wish to comment on that? Yes.

Ms. BAIR. You know, I think you're right. There is a difference. I think we were focusing on predatory lending because it's the subject of the hearing as indicated in the invitation letter. Getting back to mortgage fraud, too, another area that we address in the draft subprime guidance, these no-doc loans or low-doc loans which—and we say in the proposed guidance—in and of itself is not a mitigating risk factor. I think a lot of the early payment defaults, potential mortgage fraud, there is a correlation between no-doc, low-doc loans and these payment defaults. So that's probably near where we're talking more about poor, very poor underwriting versus something—there may not be a balloon at the other end that we need to be concerned about—but there still is a problem with the underwriting.

Mr. CAMPBELL. Anybody else wish to comment on that? No?

Okay then one of my concerns on this, Chairman Bernanke of the Federal Reserve, when he was here, was indicating that one of the—I think he indicated that the greatest risk factor to recession this year was if housing were to take a hard fall.

The object of what we're doing here, I hope, is to solidify subprime mortgage lending and not dry it up because if we dry it up, I think we could potentially put a bunch of houses on the market, take a bunch of buyers out of the market, and potentially create something that drastically hurts the economy.

Another figure that's been out there lately has been, I think, the 13.7 or 13.8 percent, something like that, of subprime loans which are currently behind in payments. I frankly can't recall whether it's 30 days, 60 days, or 90 days.

If that's the case though, it does mean that 86 percent of these people with—it wouldn't be subprime if the credit weren't marginal. So it does mean that 86 percent of these people with marginal credit because of the subprime market have been able to buy

homes whereas without the subprime market they wouldn't. Any comments on the loan—because obviously in a subprime you're going to have a higher loan default ratio than you are in a prime market or in the A-whatever-it-is market that's in the middle.

Any comments on whether that—it's obviously higher than it was, but is it way too high on a historic basis?

Ms. BAIR. Well, it is high. Historically, they have been higher, but we're seeing a strong correlation between payment resets and home price depreciation in areas with these default rates. And the adjustable rate products have significantly higher delinquency rates than the fixed rate products.

The problem is to help people restructure into a product that they can afford. One thing we've been looking at is whether we can transition borrowers into fixed mortgages, and that might be the silver lining in all of this. We've been doing analysis of the rate sheets of the major subprime lenders. The rate for their 30-year fixed is actually only 40 to 50 basis points higher than the starter rate on the 2/28 which a lot of these people are in.

So we're thinking that if you can qualify borrowers for a 2-year starter rate, you can qualify them for a 30-year fixed. And we're hoping that perhaps as these interest rates reset, and people have to refinance, we can get more people into 30-year fixed that would not have the payment shock.

Chairwoman MALONEY. Time has expired. There have been a number of issues raised about targeting vulnerable borrowers and I wanted to note that the subcommittee will be having hearings on this particular subject. The Chair recognizes Congressman Ellison of Minnesota.

Mr. ELLISON. Thank you, Madam Chairwoman. I wonder if, Ms. Bair, you could comment on how the clustering of a number of foreclosures that come about in connection with subprime loans impacts a neighborhood.

Ms. BAIR. Well, it could have a very negative impact on neighborhoods. I mean this is as I indicated in my statement, one of the reasons we support and endorse and promote homeownership and welcome it and subsidize it. I support all of this is because one of the many social benefits is that it stabilizes neighborhoods.

If you have a series of people in a situation that their homes are going to be foreclosed, and they are in danger of losing their homes, that's a tremendous stress not only just on the family but on the neighborhood as well.

Mr. ELLISON. Does it have any other kind of spillover effects beyond just the physical reality of foreclosure? I mean what happens to these homes? Are they bought by other homeowners? Are they bought up by people who can buy them cheaply?

Ms. BAIR. I think the first choice is always to try to keep people in their homes, to try to undertake loss mitigation techniques to restructure the loan to keep them there.

Yes, there are adverse economic effects as well. If we have a lot of foreclosures and a lot of housing stock going on the market, that could further depress a market that's softening in a lot of areas already.

Mr. ELLISON. Now what about those—I mean I'm glad that you pointed out that you try to get the bank to redo the loan with the

borrower, but is that always possible? I mean what if the bank has sold that loan? Can they go back to the same bank where they got it?

Ms. BAIR. That is a problem. We're having a roundtable on April 16th with the representatives of firms that securitize these loans because there may be some issues about whether the terms of the securitization agreements may inhibit the ability to restructure. That's a key area that we're going to be looking into at this roundtable, so I don't have a good answer for you right now.

Mr. ELLISON. So for example if somebody—if a bank were to have sold that loan and it got bundled up and packaged with a bunch of other loans who then does the borrower go to and try to—is it—

Ms. BAIR. They would go to whoever is servicing the loan at that point. That would be the firm, the entity that would be getting the restructuring. But again, whether the servicer has the latitude to restructure the loan under the securitization agreement is what we need to deal with and we don't have a good answer. We think there is significant latitude, but that's one of the things we want to get into at our roundtable.

Mr. ELLISON. Another question I wanted to ask you, and it goes back to the gentleman who was asking a few questions before, just in terms of how people make money on these loans, if it's a broker, isn't it the case that they already have an incentive to make sure that the borrower is going to be able to pay the loans because once they do the deal they get their money and they're out? Is that right?

So the question of whether it's bad underwriting or good underwriting or the quality of the underwriting, from a broker's standpoint, once the deal is done and their fees are paid it really doesn't matter whether it's a well underwritten loan or not. Am I right or wrong?

Ms. BAIR. Well, I think there are a lot of really good mortgage brokers out there who don't want to—

Mr. ELLISON. And I'm not trying to disparage mortgage brokers.

Ms. BAIR. And I think the reputable mortgage brokers do worry about whether their loans perform in terms of maintaining a relationship with lenders. But there are—as Commissioner Antonakes has pointed out and others on this subcommittee—significant problems with the conduct of some mortgage brokers. In that case, they are just trying to make a quick buck. You're right.

Mr. ELLISON. Yes, and I guess whenever you ask a question there are the connotations of the question, and people try to control for those so they don't put anybody down, but leaving all the nice stuff aside, after the mortgage broker does the deal they're going to be the most reputable person on the Earth, but they have completed their work—

Ms. BAIR. No, they are not on the hook for that.

Mr. ELLISON. Right. Let's just talk about the loan officer a little bit. After the loan officer has—let's say they're the one who did the deal. After that loan is sold, they've made the money they're going to make out of it and they're done; am I right?

Ms. BAIR. Yes.

Mr. ELLISON. So when it comes down to whether or not—so there really is a more serious problem than just whether—I mean they

actually—in some ways there is an incentive to have loans underwritten in a way that facilitates the doing of the deal but not necessarily the paying of the mortgage.

Ms. BAIR. I hate to qualify, but I really do feel like I need to. I think lenders, responsible lenders, do worry about their reputations and their relationships with those who acquire their mortgages to keep this pipeline open. So I do think there's some reputational risk that serves as an incentive to have well performing assets.

That said—

Mr. ELLISON. Ms. Bair, it sounds like you're saying that I'm wrong and that—

Ms. BAIR. You're not wrong.

Mr. ELLISON. Okay.

Ms. BAIR. There's no doubt that securitization has had an impact on the loosened underwriting standards we've seen by lenders. There's no doubt about it.

Mr. ELLISON. Thank you. So the answer is yes. There is an incentive—

Chairwoman MALONEY. The gentleman's time has expired. Thank you.

Mr. ELLISON. 30 seconds?

Chairwoman MALONEY. We're running out of time. We have two more speakers, Joe Baca of California and Al Green of Texas, and then we have to conclude this first panel so that we have time for the second panel.

As I said in my opening remarks, we have a time limit on the amount of time we can be in this room and we need to have time for our second panel.

Joe Baca of California.

Mr. BACA. Thank you very much, Madam Chairwoman. Thank you very much for having this hearing. I think it's very important to a lot of us, especially what's going on nationwide.

We realize the impact that it has on the poor and the disadvantaged, especially as it pertains to African Americans and Hispanics, so we appreciate having the hearing, and I appreciate the gentleman's question right now, and I wanted just to follow up a little bit with it.

Is there a list of those who abuse the system right now, and maybe when we talk about an educational process that needs to be done, whether it's financial institutions, financial education? What we need to do though is those mortgage brokers that are abusing this system, we need to put out a list of those individuals so we can begin to educate our communities—these are the bad lenders out here that are abusing the system, that are taking advantage of the poor, the disadvantaged and others who are just out to make a profit and they don't care about the individual in terms of the loans. That needs to be done, so I appreciate that.

But I want to get back to a specific question. And I want to know the impact of subprime lending on Latino homeowners. What control will be put in place to protect consumers from predatory practices and especially how will you ensure that the exorbitant fees and rates associated with subprime practices will not occur with future borrowers?

That is question number one. Any one of you can answer that, or Ms. Braunstein, would you please tackle that?

Ms. BRAUNSTEIN. Well, that was one of the reasons that we have issued the proposed subprime lending guidance was to address some of those issues about borrowers and hopefully—I think that guidance is already taking effect in the marketplace and will continue to.

Mr. BACA. But how are we holding them accountable and what oversights are we doing on those individuals who continue to still give out the loans? So there has to be some accountability for those that continue to prey on the poor, the disadvantaged, especially when I look at Inland Empire, where I come from, there's a high number of foreclosures and defaults in my area. So we're not holding those individuals accountable yet we have people that are losing their homes. And this is for the very first time that they've bought a home, they maintain a home but they have some bad advice because someone wanted to take advantage.

Ms. BRAUNSTEIN. Most of the bad actors to which you refer are not in the depository institutions, which is who we regulate and supervise. If we find that there are practices that are illegal or fraudulent in our institutions we do take action, however a number of the actors in the market that we've just talked about are not being supervised directly by anybody.

Mr. BACA. Who's responsible for supervising them?

Ms. BRAUNSTEIN. Pretty much the States.

Mr. BACA. And why aren't they?

Mr. ANTONAKES. Well, I beg to differ with my colleague in terms of them not being supervised. They are being supervised. And our database—

Mr. BACA. If somebody is making the statement that they're not supervised, then there is a concern right here, and that's affecting us in our communities. If somebody is saying that the State isn't doing it and yet when you look at the foreclosures in each of the areas and its impact—and specifically when it has—and I'm concerned from the Hispanic perspective, the foreclosures and people that are losing their homes right now.

Something needs to be done. There has to be the accountability. There has to be that oversight.

Mr. ANTONAKES. I agree completely, Congressman. And I would only add that broker supervision largely falls to the States. Through our database we will have a collection of public enforcement actions against brokers. I would also add however that certainly the securitization of loans has created incentives for prudent underwriting standards to become lax and for brokers to push through loans.

However those loans can only be pushed through if they're funded by someone, if there's a product available. The broker can't do that on their own. And that is done through other firms, lenders and national institutions and also provided by direct financing from companies from Wall Street.

I would suggest—and we've done it in my State in Massachusetts many years ago—that if a bank has lines of credit with either a lender that is pushing through predatory loans or loans that aren't underwritten appropriately that the national regulator through the

COA authority has a responsibility to take that into account, those practices. If they know that they're doing business with inappropriate lenders, then they should take action.

Chairwoman MALONEY. The gentleman's time has expired. Mr. Green from Texas.

Mr. GREEN. Thank you, Madam Chairwoman, and I thank each of the witnesses for appearing today. In one of our great documents we connote, indicate if you will that all persons are created equal. Apparently something happens between creation and loan acquisition because for whatever reasons we are finding that invidious predatory lending impacts some ethnic groups more than others and the question really is what will we do about it.

But before going to the question, let me just mention testing. Every time, every single time we have employed testing we have found that invidious discrimination exists, every single time. Given that we know that it exists, what have we been doing to combat it in terms of prosecuting persons? Can anyone comment, please?

Ms. BAIR. Again, we only regulate depository institutions, state-chartered depository institutions, in the FDIC's case. We identify outliers based on the HMDA data. We do very vigorous compliance reviews of the banks that are shown to be outliers under the HMDA data. We've referred cases already where we've identified a pattern or practice of discrimination to the Justice Department for prosecution, so we take it very seriously and we very vigorously examine for it.

Mr. GREEN. How many cases have been prosecuted by the Justice Department in the last year?

Ms. BAIR. That I wouldn't know. We could try to find out for you.

Mr. GREEN. Anyone have any information? Do you know how many within the last 5 years?

Ms. BAIR. We could contact the civil rights division of the Justice Department. No, we don't. I don't know off the top of my head, but we could try to find the information for you.

You're interested in financial services areas, yes?

Mr. GREEN. Yes, I'm interested in knowing what we actually are doing, given that we have empirical data to suggest that certain things are occurring.

Ms. BAIR. Right.

Mr. GREEN. What are we actually doing about it?

Ms. BAIR. Well, the availability of HMDA data, to the level of detail we currently have, is relatively recent. We just began getting this level of detail last year, so our ability to use this as a tool is a fairly recent vintage.

Mr. GREEN. Let me move on to something else. We have a number of families who will lose their homes and as a result they will have credit problems. What are we doing to give them an opportunity? Assume that you are foreclosed on, what are we doing to give them an opportunity to reenter the credit market and have another opportunity to own a home given that we know that we have a circumstance with the housing prices falling and with a lot of these loans being subprime? What are we doing to give them an opportunity to get back into the housing market?

Mr. REICH. Well, to the extent that these families are in homes, the mortgages are held by the depository institutions that we regu-

lators regulate, we are encouraging the institutions to work with these families prior to the foreclosure completion to forestall a foreclosure or to try to prevent a foreclosure from taking effect.

Mr. GREEN. After foreclosure, what are we doing? We have literally, my suspicion is, millions of persons who will find themselves losing their homes, and we want to give them an opportunity to get back into the market.

Let me go to the next question. What about the cost of this? What is it going to cost in terms of dollars with all of the foreclosures? What will be the amount of money that the marketplace will lose due to the foreclosures? Anyone know?

Mr. REICH. It's difficult to project.

Mr. GREEN. Is it billions?

Ms. BAIR. I think there is a recent study, it's not a government study, that estimated—I think it was about $140 billion over the next 6 years.

Mr. GREEN. $120 billion?

Ms. BAIR. $140 billion.

Mr. GREEN. Total?

Ms. BAIR. Over the next 6 years. We can get you a copy of the study. I'm going off the top of my head, but I think that was the ballpark about what they—that is one private sector study.

Mr. GREEN. If we bonded many of these persons who are going to be foreclosed on, would they—with a better interest rate would they be able to stay in the marketplace and maintain their homes? Anyone?

As some States are doing, bonding?

Ms. BAIR. Sir, I'm sorry. I should not have spoken off the top of my head. Over 6 or 7 years—would result in loses of about $112 billion. It's 143,000 foreclosures every year over the next 6 years.

Mr. GREEN. Here's my closing comment, Madam Chairwoman, and thank you. We are spending about $333 million a day on the war. We seem to find the money to cure the ills that we deem to be a priority. It seems to me that we ought to do more to find a way to help people maintain their homes given that we know that some of the circumstances that are causing them to lose their homes are somewhat shady, and that's being kind. I think we need to do more, and I yield back the balance of my time.

Chairwoman MALONEY. That's a good point to end on, and we are out of time. I would like to follow up on the point that the gentleman made on enforcement or the lack thereof. And I would like to ask a question. My time has expired, so if you would, get back to me in writing.

If the guidance were made for the whole market, who would enforce that for each of the different sectors? The Truth In Lending enforcement plan would give the FTC enforcement authority over a large part of the market, but as several of you have testified the examination powers of the Federal banking regulators are important. So your comments—if you could, get back to us in writing on how we would make the enforcement go forward. And I would just like to end with that point that many of you made that the bankers will not be selling these loans if lenders don't make them.

And going back to the guidance, which basically says that you do not make loans to people who cannot afford it, would in many ways adjust and correct this market.

I would like to say that the Chair notes that some members may have additional questions for this panel, which they may want to submit in writing. And without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

I want to thank you for your testimony today and for your attention to this very pressing problem. Thank you very much.

[Recess]

Chairwoman MALONEY. The subcommittee will come to order. We have a limited amount of time remaining to us. Our second panel this afternoon consists of several distinguished members as well. We have: Michael Calhoun, president of the Center for Responsible Lending; Josh Silver, vice president of research and policy for the National Community Reinvestment Coalition; Allen Fishbein, director of housing and credit policy for the Consumer Federation of America; John Robbins, chairman of the Mortgage Bankers Association; Harry H. Dinham, CMC, president of the National Association of Mortgage Brokers; and Mr. Alex Pollock, resident fellow, from the American Enterprise Institute. And without objection, the witnesses' written statements will be made part of the record. You will each be recognized for a 5-minute summary of your testimony. The Chair now recognizes Mr. Calhoun for 5 minutes.

STATEMENT OF MICHAEL D. CALHOUN, PRESIDENT, CENTER FOR RESPONSIBLE LENDING

Mr. CALHOUN. Thank you Madam Chairwoman, Ranking Member Gillmor, and members of the committee, for the opportunity to speak to you today about the causes, the impact, and most importantly the reforms necessary to address the foreclosure crisis seen today in the subprime market. First, I think it's important to look at what the typical subprime loan today is like, and when you do that, you will quickly see a lot of the origins of our problems.

The typical subprime loan today has a built-in payment shock of 40 to 50 percent, even if market rates do not increase. For example, a typical subprime loan starts at 7½ to 8 percent, and when it readjusts as you have heard about today, it will jump to nearly 12 percent again, even when market rates do not change. That same loan typically has no escrows for taxes or insurance, making them due in a lump sum, which further stresses the borrower. It's based on undocumented income and it typically comes with a prepayment penalty that most borrowers end up paying. As a result of that, our research shows that over 2 million borrowers in the subprime market will lose their homes.

And it is important to put that in context, as people have said today. Subprime loans make up less than one-sixth of the overall mortgage market, yet they are producing almost two-thirds of all foreclosures in the entire mortgage market today. We have done further research which is set out in detail on page 13 of my testimony, that shows the macro impact of this on homeownership. Going back over a 9-year period, it shows that the net impact is

almost a million more families lose their homes as a result of subprime lending than are to homes as first-time homebuyers.

That's driven by two pieces of data. As Representative Miller noted, a very small percentage of subprime loans are in fact first time homebuyer loans. And then second, you have these very high levels of foreclosures. You put those together and you have the fact that today the subprime market has been a destroyer not a creator of homeownership for American families. As Chairwoman Bair noted, that's not only tragic, it's unnecessary. As she pointed out, a subprime borrower can receive a standard 30-year fixed rate mortgage at a lower rate and lower monthly payment than they would receive one of these 2/28 TSR arms with a built-in payment shock. But market dynamics make it more profitable for participants in the mortgage market to give them that much riskier loan. What reforms are needed?

First of all, of course, the guidance that we talked about should be implemented. There are major attempts though of push-back by some lenders who openly criticize that guidance, and that must be fought off. Second, the HOEPA Authority under the Fed; the responsibilities of the GSEs to meet the standards must be followed. Families in foreclosure also need help with workouts. FHA, which I think you will address soon, will play a major role.

There also are two legal impediments for these families now that I urge you to investigate. First the tax code often makes loan forgiveness taxable to the borrowers, so even if they are able to get loan forgiveness, they can still get a notice from the IRS saying that they owe tens of thousands of dollars in additional taxes. Second, the Bankruptcy Code is presently stacked against homeowners, making it almost impossible for them to modify and get relief when they are behind on their mortgage.

Finally, there needs to be action on a national bill for sustainable home lending. At the top of that list needs to be addressed the broker role, which is being addressed today. First, under current law, brokers are generally allowed to disclaim any duty to the borrower. It needs to be affirmatively established that they have a fiduciary duty to the borrower. Second, today, brokers are even allowed to receive bonuses for putting borrowers in higher interest loans than they qualify for. That should stop, most importantly for enforcement. Lenders need to be held responsible for the acts of brokers. That's the self-enforcing market mechanism that's been needed.

There's been talk here of education. Let me suggest—we don't tell purchaser's of insurance policies to go educate themselves by reading insurance books to make sure that their insurer doesn't go out of business. It is much the same in the mortgage market. There need to be substantive standards. Education has a role, but it won't be the only solution.

Finally, there needs to be flexibility. It was indicated today that the 1999 North Carolina Mortgage Predatory Lending law did not address a lot of the practices that we see today that developed in only the last couple of years. I think you will see further action by North Carolina in this legislative session.

Thank you for this opportunity to share our comments.

[The prepared statement of Mr. Calhoun can be found on page 288 of the appendix.]

Chairwoman MALONEY. Thank you very much.

The Chair now recognizes Mr. Silver.

STATEMENT OF JOSH SILVER, VICE PRESIDENT OF RESEARCH AND POLICY, NATIONAL COMMUNITY REINVESTMENT COALITION

Mr. SILVER. Chairwoman Maloney, Ranking Member Gillmor, it is an honor to be here today as a voice for the over 600 community organizations that comprise the National Community Reinvestment Coalition. NCRC is the Nation's economic justice trade association dedicated to increasing access to fairly priced credit and capital for minority and working class families. We stand on the precipice of a mortgage tsunami in the United States.

According to the FDIC, interest rates are due to rise for borrowers of one million subprime loans in 2007, and another 800,000 borrowers in 2008. In numerous cases, unsuspecting borrowers discover that the introductory TSR rates on subprime ARM loans have expired and are replaced by unaffordable monthly payments. More than 14 percent of outstanding subprime loans were delinquent by the end of 2006,

The final regulatory guidance on non-traditional mortgages and the proposed guidance or subprime arm loans are necessary but not sufficient to save us from hundreds of thousands of foreclosures. The guidance requires lending institutions to assess borrower capacity to repay at the fully indexed rate, not the TSR rate. The sound underwriting in the proposed guidance should eliminate many of the abuses in the unsafe and interceptive ARM subprime lending. Yet, the guidance does not come close to providing comprehensive coverage. It applies to about half of the subprime lending, which is conducted by banks, thrifts and their affiliates. It does not cover prime ARM lending, which can also be problematic when TSR rates are low and when the APR is in the upper ranges of prime pricing. The guidance also cannot directly cover non-banking institutions, including brokers, appraisers, closing agents, securitizers, and services, all of whom contain abusive actors perpetuating and enabling dangerous lending.

While the regulatory guidance is a good start, Congress needs to pass a comprehensive anti-predatory lending bill. You will hear industry representatives insist that policymakers should not overreact and, therefore, choke off lending and the American dream of homeownership. These assertions, however, fail to recognize that lending markets are broken, as Representative Ellison was trying to draw out. The problem is there is a lack of financial incentives for the actors, brokers, and securitizers and several other actors to behave responsively.

NCRC's experience and research demonstrate that the broken marketplace needs a major fix in order to avoid the tsunami. NCRC operates a foreclosure prevention program called the Consumer Rescue Fund and engages in mystery shopping on a national level. In my written testimony, I describe a number of Rescue Fund cases in which borrowers of subprime ARM loans experience multiple abuses committed by appraisers, brokers, loan officers, and

servicers. Tragically, NCRC has reaffirmed that these overwhelming abuses are disproportionately experienced by minorities and hard-working Americans—the very same families that industry trade associations want to protect from more regulation and consumer protection.

We conducted national level mystery shopping of subprime mortgage companies and brokers in several metropolitan areas. We armed our minority mystery shoppers with better qualifications.

Yet, they consistently received less service, higher subprime rates, and fewer loan options than white shoppers. When we combined credit within this data, it withheld the data. We found that the portion of subprime lending was higher as a portion of minorities and the elderly was higher enablements in several large metropolitan areas. CRL and Federal Reserve economists have found the same things. The lending marketplace is broken and the victims are disproportionately minorities, the working class, and the elderly.

So, I conclude with three major policy recommendations. Congress must swiftly pass a strong comprehensive anti-predatory lending bill. The abuses are too pervasive and cut across too many actors in the industry to be tackled successfully by regulatory guidance. Second, Congress must pass the CRA Modernization Act of 2007, H.R. 1289. The Federal Reserve has found that CRA encourages banks to make more prime loans, thus, CRA acts to increase product choice in working class and minority neighborhoods.

CRA also provides fair lending reviews, checking for abusive lending. CRA must be applied to all bank affiliates, large credit unions, and independent mortgage companies. Recently, NCRC called on the Administration and Congress to re-till the FHA program so they could offer rescue refinance loans to victims of predatory lending. In addition, Congress should consider a national foreclosure fund to offer remediation for families experiencing foreclosure through no fault of their own.

It is time to put American families first. Hundreds of families and children are losing their homes every day due to predatory lending. That is not a marketplace that is working. Haven't we deregulated enough? It is time to end the suffering and save the American dream of homeownership by passing a strong national anti-predatory lending bill.

Thank you so much.

[The prepared statement of Mr. Silver can be found on page 315 of the appendix.]

Chairwoman MALONEY. Thank you so much.

Mr. Fishbein?

STATEMENT OF ALLEN FISHBEIN, DIRECTOR OF HOUSING AND CREDIT POLICY, CONSUMER FEDERATION OF AMERICA

Mr. FISHBEIN. Chairwoman Maloney, Ranking Member Gillmor, and members of the subcommittee, it is a pleasure to be here today to testify on behalf of the Consumer Federation of America. And, we congratulate you for holding these hearings, which are coming at the timeliest of times.

CFA is a national federation of some 300 pro-consumer organizations established in 1968 to engage in research, public education,

and advocacy in support of the interest of consumers. The goal of advancing sustainable homeownership is an important one for CFA and its members. Homeownership can have many benefits, not the least of which is the opportunity it provides to build personal wealth. But these advantages are being eroded by the mass marketing of high risk non-traditional mortgage products to many consumers for whom they are not appropriate. What these loan products have in common is that they trade lower initial monthly payments for higher payments later that can escalate dramatically, making these loans unaffordable for unsuspecting borrowers.

The abandonment in recent years by many lenders of careful underwriting based on the borrower's ability to repay without refinancing or selling their home has made these loans even riskier. Of particular concern are the high adjustable rate mortgage products that Mr. Calhoun and others have spoken about that became the predominant product in the subprime market. Until about a year ago, rising home prices and relatively low interest rates made it possible for borrowers to refinance or sell their homes after the initial period ended, or if they ran into trouble making payments. This masked the fact the fact that many lenders were qualifying borrowers based on the loans start rate, when home price appreciation leveled off as it did last year, delinquencies and defaults took off rising to the highest level in a decade.

Delinquencies usually rise when the housing market slumps because borrowers are more likely to encounter difficulties in selling their homes. In addition, if the prices fall, borrowers may find themselves without the necessary equity to refinance it to a more affordable loan. And this is why we are seeing this problem mushrooming right in front of our eyes. The widespread use of exploding payment ARMs, and other payment deferred, non-traditional mortgage products points to a fundamental concern about whether consumers really understand just how much their monthly payments can jump with these and other risky products.

In my written testimony, we discuss several examples of research indicating that many consumers do not understand these terms. CFA believes, therefore, that it is an opportune time to examine the efficiency of steps that have been taken and whether additional action is warranted. We also believe that more focus should be directed at financial institutions, investors, government, and the nonprofit sector to find creative solutions for keeping at-risk families—who have been victimized by lax underwriting—in their homes. In my written testimony, we summarize three areas of particular attention and I would like to just highlight them.

First, the lack of accountability for key actors in the marketplace. Risk to consumers is vastly different today than risk to the industry. Lender's today can shield themselves from the full potential impact of foreclosures by selling their loans to investors through mortgage securities. In effect, higher foreclosure rates have become the cost of doing business. This presents risk for individual home borrowers who cannot insulate themselves the same way against this higher risk.

Mortgage brokers who originate the majority of subprime loans have an incentive to close as many loans as possible and a very good reason not to consider the loan's future performance. The lack

of effective oversight and consumer protections, both the front and back ends of the subprime market, are contributors to the problem we are witnessing today.

And we have one suggestion for one of your future hearings and that is to invite the Securities and Exchange Commission to be here and talk about what they think are the nature of some of the problems in the marketplace, and whether current regulations that they oversee are adequate.

Two, the Federal Banking Agency guidance, while it is helpful and will help correct some of the abuses in the marketplace, is not enough. Additional steps are needed. Finalizing the proposed subprime statement that was issued by the regulators on March 8th would help to restore sound underwriting for subprime loans. We support its quick adoption. I would also like to offer a letter from some 70 organizations, written to the regulators on February 21st asking for the issuance of guidance along these lines.

At the same time, we recognize that there are important limitations to this policy guidance and it will take a long time to be fully implemented. Thus, we support the need for a comprehensive rewriting of consumer protection laws, which we feel need to be updated.

Thank you.

[The prepared statement of Mr. Fishbein can be found on page 346 of the appendix.]

Chairwoman MALONEY. Thank you so much, and we are considering having a hearing along those lines.

Mr. Robbins.

STATEMENT OF JOHN M. ROBBINS, CHAIRMAN, MORTGAGE BANKERS ASSOCIATION

Mr. ROBBINS. Thank you for the opportunity to speak about an issue that has captured the attention of this committee and the financial services industry. As Mortgage Banker's Association statistics show, delinquencies and foreclosures have risen over the past 6 months, particularly in the subprime market. In response, regulators have established new standards. Investors have punished companies that made bad loans, and I am here today to answer your questions about the effect it is having on consumers.

I believe MBA's data in a written statement is both objective and comprehensive, and I am confident that it is the most authoritative in its data because it includes 86 percent of all outstanding mortgages. Economics aside, I want to talk today from the heart as someone with 36 years of mortgage experience, and what I have seen of late troubles me deeply. Responsible lenders only extend credit to borrowers who are willing and able to make mortgage payments. They do not trick borrowers into loans that are unsustainable and they do not hold on something that is only a mirage of the American dream.

I have conducted my professional life according to these standards as has nearly every member of the Mortgage Bankers Association. Yet, bad loans were made. They were not made responsibly or with the best interest of the consumer in mind. For the most part, those making these poor loans have been punished by Wall Street and restrained by regulators, and while we must ask what

lessons we should learn from these mistakes, it is equally important for those in positions of authority to help current homeowners stay in their homes.

Working together, I suggest that we accomplish three things: stabilize the subprime mortgage credit system; provide assistance for homeowners facing foreclosure; and, finally, prevent this from ever happening again. First, reaction from investors has been swift. Already, more than 20 subprime lenders have closed their doors. As we watch this, we must remind people not to confuse subprime with predatory, and, we must reiterate that while subprime foreclosures are high, at 4½ percent, currently they remain below their historic peak of 10 percent. A sound perspective and a prudent regulatory hand will seize investors, calm editorial writers, and most importantly, help consumers.

Second, for subprime borrowers who are facing foreclosure, industry and policymakers must partner to help provide options so that as many as possible are able to retain their homes. Chairman Dodd recently called for a summit of all parties to address this problem. MBA embraces that idea. Further, we at MBA strongly encourage all borrowers who find themselves unable to make payments to contact their lender immediately. Lenders lose money on foreclosures—in my company, it was $40,999 for each one—and so they have have a strong desire to make any number of arrangements that would allow a borrower to start making payments again and keep his or her home.

Third, lawmakers, regulators, and industry must work to ensure that this situation does not occur in the future. Borrowers are smart. When given good information, they make good decisions, but they make poor decisions when they have bad information. And, absence of pricing transparency coupled with the daunting and complicated closing process has permitted certain actors to prey on the unsophisticated. But frankly, every person from subprime to jumbo borrower is susceptible when even the chief executive officer of FNMA and the Secretary of HUD by their own admission cannot understand all the documents at a mortgage closing.

The mortgage market is desperate for a rewrite of the Nation's settlement laws and a strong uniform lending standard to trap predators and bring them to justice. I stand ready to meet with each member of the financial services committees to discuss what MBA will do to work to accomplish these goals. Together, we can ensure that predatory lenders don't foreclose on the American dream.

[The prepared statement of Mr. Robbins can be found on page 360 of the appendix.]

Chairwoman MALONEY. Mr. Dinham.

STATEMENT OF HARRY H. DINHAM, CMC, PRESIDENT, NATIONAL ASSOCIATION OF MORTGAGE BROKERS

Mr. DINHAM. Good afternoon Chairwoman Maloney, Ranking Member Gillmor, and members of the committee. I am Harry Dinham, president of the National Association of Mortgage Brokers. NAMB is committed to preserving the vitality of our cities and the goal of homeownership. We commend the subcommittee for holding this hearing. NAMB is the only trade association devoted

to representing the mortgage broker industry. Mortgage brokers must comply with a number of State and Federal laws and regulations. We are subject to the oversight of not only State agencies, but also HUD, the FTC, and to a certain extent, the Federal Reserve Board.

First, let me say, it is a tragedy for any family to lose their home to foreclosure. No one disputes this. Foreclosure hurts not only the family, but the neighborhood and surrounding communities. As small business brokers, we live, eat, shop, and raise our families in these communities. When consumers' properties decline, our property values decline. When consumers' neighborhoods become unstable and prone to violence, our neighborhoods become unstable and prone to violence. More than any other channel, brokers live by the motto: Once a customer, a customer for life. What happens in our neighborhoods and in our communities hurts all of us. Mortgage brokers do care. We believe everyone from Wall Street to mortgage originators should work together to develop and implement appropriate solutions. At the same time, we must remember that today America enjoys an all-time record rate of homeownership, almost 70 percent.

The challenge we face now is how do we help people avoid foreclosure, and at the same time ensure that they have continued access to credit. We realize that a number of recent reports have focused on the rise in home foreclosures. The truth is that we can only speculate on the causes responsible for the rise in home foreclosures. There are a number of possible factors: bankruptcy reform, minimum wage gains, credit card debt, decreased savings rate, decreasing home values, second homes, fraud, illness, and other life events, to name just a few.

Do not rush to judgment before we have all the facts. We understand that Congress will be calling for a GAO study on the causes of foreclosure. We expect the study to take into account a number of possible economic and non-economic factors. We should examine the conclusions before implementing any policy decisions that could unfairly curtail access to credit. A President challenged the industry to increase minority homeownership by 5.5 million families by 2010. Wall Street investors, securitizers, rating agencies, underwriters, realtors, and originators responded in an effort to help families own homes.

The events of the past 2 decades have created a mortgage market. Where today Wall Street creates a demand for certain mortgages and sets the underwriting criteria for these mortgages, it is this criteria and not the mortgage originator that decides whether the consumer qualifies for a particular loan product. With this said, all of us, industry, government, and consumers, have a role in helping these families stay in their homes.

Here is a brief summary of what NAMB is doing to help families achieve and maintain responsible homeownership. We support the intent behind some of the key principles of the proposed guidance, as well as the need to expand this application once finalized to all market players to ensure uniformity and a level playing field. We continue to advocate for affordable housing, including FHA reform, and have pushed for increased mortgage broker participation in the

program. We must make FHA a real choice for non-prime customers.

We support authorizing VA to provide reverse mortgages and expand access to credit, especially for elderly veterans. Since 2002, we are the only trade association that has advocated for education, background checks, and increased professional standards for all mortgage originators, not just mortgage brokers. We continue to oppose the flawed system proposed by CBS Armor, because it is riddled with exemptions, enables bad actors to move freely unchecked, and will give consumers a false sense of security,. It does not effectively address mortgage fraud or accountability.

We prepared and submitted to HUD a revised good faith estimate to help improve comparison shopping. Our code of ethics and best business practices prohibit placing pressure on, or being pressured by, other professionals and we proposed the development of loan specific disclosures to be given to consumers at the shopping stage and beginning of funding. This would help consumers avoid payment shock.

Thank you for the opportunity to appear today. I am happy to answer any questions.

[The prepared statement of Mr. Dinham can be found on page 392 of the appendix.]

Ms. MALONEY. Thank you.

Mr. Pollock.

STATEMENT OF ALEX J. POLLOCK, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. POLLOCK. Thank you, Madam Chairwoman, Ranking Member Gillmor, and members of the committee, for the opportunity to be here today. I will use my 5 minutes—and I noticed that the Chair is rigorous in enforcing the 5 minutes—to try to make five points: One, the classic credit overextension pattern of the subprime mortgage bust; two, the trade-off between risk and homeownership as a market experiment; three, fraud; four, the proposed regulatory action; and five, my proposal for a one-page mortgage disclosure document. Congressman Hensarling and Congressman Scott both mentioned the difficulty, as have other commenters, of understanding what you are getting into with a mortgage. I propose this one-page disclosure idea, which I will talk about more in a minute.

First, as we all know, the subprime mortgage boom is over and the bust is here. And Ranking Member Gillmor, unlike the members of the other panel, I am more pessimistic about where busts go, all of the connections that you don't necessarily see when you first look at it, when there are serious credit problems.

In the mortgage market and in the wider economy, this is consistent with the context, which is that all of the elements of the current subprime bust display classic errors of credit overexpansions, which are very familiar to students of financial history, and which many of us have lived through before. It is essential to remember that the boom gets going because both lenders and borrowers experience success in the beginning. As long as the asset price is rising, taking on risky debt by a borrower and making risky loans succeed, and that success and belief in the continuing

asset price rise ultimately sets up the bust. That is true whether the asset is dot com stocks, oil, commercial real estate, houses or anything else. It is first, success which builds up the optimism which creates the boom which sets up the bust.

Second, there is a constant trade-off being made between risk and homeownership. The American homeownership rate, as many have pointed out, has moved up to 69 percent. On an international basis, this is a good but not remarkable ratio. The United States ranks tenth, is actually tied for tenth, among advanced economies in homeownership ratio. The mortgage market is constantly experimenting with how much risk there should be, how that risk is distributed, and how it trades off with success or failure of lenders and borrowers. If we want the long-term growth and innovation that only market experimentation can create, then we will have boom and bust cycles. In economics, nothing is free. You can move the risks around, but you cannot make them disappear.

Many people have rightly brought up the long-term, fixed rate mortgage loan, which is an excellent instrument, but I would remind the subcommittee that this form of mortgage caused the collapse of the savings and loans in the 1980's. Subsequent to that, to preserve the fixed rate mortgage required vastly expanded securitization. But securitization, as other people have pointed out, breaks the link between the originator of the mortgage loan and who actually bears the credit risk. Nothing is free; everything is trade-offs.

Third, fraud. Unfortunately, booms induce fraud. This is the testimony of history. This results in scandals on the part of both lenders and borrowers in some instances. Thus, we have fraud in multiple directions. Consider in this context, so-called "stated income" loans. You would think that the disastrous previous experience with this bad idea, then called "no doc" or "low doc" loans and now "liars' loans" would have been remembered, but it seems to have been forgotten by the lenders. On the other hand, I would like to point out that any borrower who lies about their income in order to get a loan hardly qualifies as a victim.

Fourth, it is late in the cycle, as has been observed. Losses are rising; credit is tightening; liquidity is disappearing; asset prices are falling; and it is hard to do the right thing as a regulator that is both in line with prudent standards and doesn't induce further tightness and reduction in credit. It seems to me the proposed statement on subprime mortgage lending is in general a sober and sensible attempt to balance these pressures, although how to set the final balance is still open.

I will mention what hardly anyone has mentioned today: down payments and savings. One mortgage lender was quoted as saying recently, "Well, we'll just have to tell some borrowers they have to save for a down payment." That struck me as quite a novel idea. Imagine that. You might have to save.

Finally, the one-page disclosure: It has been pointed out that the complexity and opacity of closing documents, many ironically mandated by regulation and law, makes it hard for borrowers to understand what they are doing, even for quite sophisticated people. I have had, as I am sure we all have, the experience of being over-

whelmed and befuddled by the huge stack of closing documents full of confusing language.

We could have a one-page disclosure form—my written testimony details what it should look like—which would make it impossible for borrowers to be unsuspecting or surprised that the rate went up. Or, to discover they had a prepayment fee after the fact; we have to always know that before the fact.

Thank you, Madam Chairwoman.

[The prepared statement of Mr. Pollock can be found on page 428 of the appendix.]

Chairwoman MALONEY. I thank all of the gentlemen for their testimony. I am told we may have a vote at any moment, at which point we will not be able to continue with the panel as another committee is scheduled to come in.

But I would like to ask all of the panelists this one question. Even as the subprime market was looking more and more risky, the incentives for borrowers, lenders, brokers, and investors kept expanding the market into riskier and riskier products.

How can we change the incentives at each step of the chain so that we encourage sound lending practices? And, I would like to start with you, Mr. Calhoun.

Mr. CALHOUN. Thank you, Madam Chairwoman. As I indicated in my comments, you can start at the beginning; the majority of subprime loans, by a good margin, were originated by mortgage brokers. They have in testimony just recently in the Senate stated, though, that they believe they have no legal duty to be watching out for the best interests of the borrower. And, furthermore, they state that they are an independent agent when it comes to the lender. And what that means in practical terms is that a borrower placed into an abusive and even illegal loan that is originated by a broker often has no effective recourse.

Also, the lender has—rather than an incentive to police the broker as has been suggested today—has just the opposite in today's market. Because the broker claims they are an independent agent, it is the lenders who have managed to turn the other way in being knowingly ignorant of what happens with an abusive loan. And then they say, if there are problems later, don't blame me. I just funded the loan. You go find the broker, and, by the way, that isn't going to help you with the servicer on Wall Street who is foreclosing on your loan. So, there has to be connections of feedback and responsibility in the origination chain.

Mr. SILVER. As an economics student at Columbia University, we talked about asymmetry of information and when actors don't internalize, negative externalities. Those are two fundamental flaws; could be two fundamental market failures. And, indeed, that is happening, sadly, in the lending marketplace. One way to eliminate these violations of classical economic theory is to create strong standards that all the actors must adhere to.

Last session, we had the Miller-Watt-Frank anti-predatory lending bill. I think that bill established some excellent standards. The proposed subprime guidance also establishes some very reasonable standards. To enforce these standards, you have to hold the actors financially reliable. For example, if people don't get tickets for speeding, you are going to have more speeders and more reckless

driving. Likewise, if we don't have financial liability on all the actors, brokers, lenders, and the secondary market and servicers, you are going to have continued problems and continued passing of the buck. Thank you.

Chairwoman MALONEY. Thank you. Mr. Fishbein?

Mr. FISHBEIN. This is an important question and thank you for asking it. Basic Federal consumer protection laws were written at a time when depository institutions were the prime funders of mortgages. I am speaking of the Truth-in-Lending Act, HOEPA, and the Real Estate Settlement Procedures Act.

A lot has changed since those laws were written. Mortgage brokers, as has been pointed out, are the channel for 70 percent or more of subprime loans. The secondary market has become much more active in securitizing these loans. But yet, the basic consumer protection laws have not been changed to reflect the new realities of the marketplace.

Having a standard that applies to loan originators, whether they are mortgage brokers or lenders, one that would require them to operate under a duty of good faith and fair treatment to borrowers, would help address some of the basic problems that you are hearing about today. With regard to the secondary market, it would help to extend assignee liability so that the purchasers of loans or the investors in these loans have some responsibility for loans that are not based on ability to pay standards or in fact have predatory characteristics.

Further, would be to make sure that the banking regulators are doing all they can to extend the reach of their authority. For example, it is not clear whether the new non-traditional mortgage guidance issued last September and the pending subprime guidance reaches to warehouse lines of credit, which depository institutions are providing to lenders, or, for that matter, their investment in securities trusts.

We think all of these things need to be looked at very carefully and we encourage the subcommittee to do that.

Chairwoman MALONEY. Thank you. Mr. Robbins?

Mr. ROBBINS. The marketplace is working. Over 20 subprime companies have gone out of business. Other companies have been substantially punished with repurchases and are showing losses. So, to the extent that the market punishes bad players, that has occured, is occurring, and will continue to occur. But, fundamentally, the system is broken and the system is broken because it is not transparent. There is no clarity to this system.

I don't think there is one borrower in a thousand who understands the papers that they sign; the number of times they sign it. It allows predatory lenders to hide underneath that moray and morass of very complicated papers that they see at a mortgage closing. We need licensing of mortgage lenders. We need education, financial literacy, and we need education at all levels, both at consumers and at high schools. We need to make the system clear.

Chairwoman MALONEY. My time has expired. I invite the panelists to respond in writing if they would like to expand further on the question. I believe it is an important one. Mr. Gillmor?

Mr. GILLMOR. Thank you, Madam Chairwoman. I have a question for Mr. Dinham. Let's assume that most mortgage brokers are

honest. They do a good job. But, as you indicated, there are some bad apples. So, my question, is for a borrower under the current system, is there any practical way for them to find out if the person doing the lending has had any kind of disciplinary action, any criminal activity, and if there isn't a practical way to do that, should there be?

Mr. DINHAM. Yes, sir. We would agree that feature needs to be there. I can just relate back to the State of Texas. They have a Web site which has all the occurrences against a particular broker. So, all you have to do is have his number, which is clearly displayed on his wall. And you can go on the Web site and see if there has been any kind of a problem that he has been in at that point. So, in other words, a lot of us are licensed and we are subject to the laws of our States. And those States all have Web sites and they all have the ability. And the consumer can go to the regulator and find out whether the broker has been in trouble or not.

Mr. GILLMOR. That would not be all States, sir.

Mr. DINHAM. Well it would be Texas, for sure. But, I think there are 49 States that have registration or licensing at this point.

Mr. GILLMOR. Thank you. I yield the balance of my time to Mr. McHenry.

Mr. MCHENRY. I'd like to thank the member for the time. To Mr. Calhoun, the Center for Responsible Lending, what are the total number of residential mortgage loans that you sold into the secondary market in 2006? You alone with the self-help credit union?

Mr. CALHOUN. I don't have the exact number. I can tell you that it is probably in the range of a billion dollars, but I would need to get back with you with a specific dollar amount.

Mr. MCHENRY. I would certainly appreciate the total number, the dollar-value, and what percentage to the marketplace. To both CRL and to you, Mr. Silver, you both talk about subprime or nonprime hurting the mortgage market and hurting homeownership in essence. Mr. Silver went so far to say the lending market is broken.

I reference you both to the previous panel of all the regulators that we had before here. I asked a simple question: Is the marketplace working? The only thing they said unanimously was yes, the marketplace is working. The mortgage marketplace is working. And so, it is wonderful rhetoric, but I think it is empty based on facts. To you, Mr. Calhoun, you referenced that 2 million will lose their homes. Over what period is that? Is that your prediction for the next year?

Mr. CALHOUN. We did an exhaustive study: the first to look at what happens to loans over the life, not just a snapshot.

Mr. MCHENRY. Sir, I have very little time.

Mr. CALHOUN. We looked at the loans originated since at least 1999 through 2006, and the projection is that over the life of those loans, 2.2 million of them will result in the homeowner going bust.

Mr. MCHENRY. In roughly 30 years, over the period of a 30-year mortgage, almost all of these would go into foreclosure. How many would go into foreclosure this year? Do you have a number on that?

Mr. CALHOUN. I can give you numbers. Yes, sir. In my testimony—

Mr. MCHENRY. The 2.4 million you reference in your study would say that in essence 30 to 40 percent of subprime loans will go into foreclosure, because there are 6 million subprime loans. That is an astronomical sum not based on any historical data in the last 40 years of lending history in the United States. And so, it is rather high and misleading before this committee.

Furthermore, you reference, so just to understand that, there are 6 million subprime loans in the marketplace right now. You are saying that basically a third of them are going to going to foreclosure.

Mr. CALHOUN. That's not correct. Those numbers are in error. If you look at the data, we say that 19.4 percent; and you look at a lot of the rating agencies are 30 percent.

Mr. MCHENRY. Which is twice as high than any historical high and the losses in subprime, and the high was 10 percent. We are under 10 percent and right now the subprime marketplace, I think Mr. Robbins references what, 4½ percent are facing foreclosure.

Mr. CALHOUN. Those are different numbers. The 10 percent, the 4½ percent he refers to are snapshots. How many are in foreclosure right now? Our number is not how many are in foreclosure at one particular time. It is if you look at what happens to that loan over its life, which is typically a 3- to 4-year time period. What percentage of those who foreclose and lose the home before the loan is paid off or refinanced?

Chairwoman MALONEY. The gentleman's time is up.

Mr. MCHENRY. Will you answer my questions for the record?

Chairwoman MALONEY. Certainly, the members can place their questions into the record, and I call on Mel Watt from North Carolina.

Mr. WATT. Thank you, Madam Chairwoman. Mr. Dinham, I just want to get a little clarification. There are obviously some problems with the broker system, disproportionately generating issues that need to be addressed. How do you define who a broker works for? How does the industry say? If I come to you and ask you to get me a loan, who are you working for?

Mr. DINHAM. Well, at this point we have contractual obligations to the lenders. Otherwise, we sign a contract with them.

Mr. WATT. So, you are saying your first responsibility is to the lender.

Mr. DINHAM. I am saying that we are a loaner store with products available to the public; and, in other words, we don't. It's like going into another type of store. We are a mortgage store. We have different products for the consumers to use.

Mr. WATT. Okay, well that's fine. I guess I have misunderstood because most brokers will tell you that they work for the borrower. I mean, I am just telling you what my experience is. You are saying that your primary responsibility is to the lender.

Mr. DINHAM. Yes, sir, because I have a contractual obligation with you. In Texas, we have a disclosure that we give to the borrower.

Mr. WATT. Where you have a contractual obligation to the borrower?

Mr. DINHAM. No, sir.

Mr. WATT. None?

Mr. DINHAM. No, sir. I have a disclosure in which I tell him exactly what the relationship is that we are going to have together at this point—that we are a contract person and not an agent.

Mr. WATT. So, if a broker in North Carolina, for example, that Mr. Bachus used this morning had a mortgage brokerage company that was placing loans had a construction company and then had a mortgage brokerage company. And they put out a brochure that said, "There are no sales people in this office. The people you work with are working for you." They put this out to the borrower. They are working for you to secure the best possible deal on your behalf. Then that would be a fraudulent, misleading, dishonest statement, is that what you are saying?

Mr. DINHAM. I am just telling you, no. I am not going to say that, because I can't unequivocally say that. But I think that—

Mr. WATT. If they were a broker, and they put out a statement to me as a borrower, saying that the people you work with are working for you to secure the best possible deal on your behalf. Would that be a misrepresentation?

Mr. DINHAM. Not if the statement was coming from me. No, sir, it would not be a correct statement. I would like to draw on what you brought up about North Carolina though, because there was an article in the Charlotte Observer which was out, I think either on the 17th—

Mr. WATT. Let's let that speak for itself. I will by unanimous consent put the actual series of articles in the record. The articles will speak for themselves. And, if you want to address the content of the articles, I welcome you to do that.

Mr. DINHAM. Okay.

Mr. WATT. Let me just get one more question in to Mr. Calhoun. We are operating now in a little bit of a different environment than we were operating over the last couple of years when we started this process of trying to produce a predatory lending bill that I would liken somewhat to what went on at Enron, and a lot of people say we overreacted to the Enron situation. I think there was some irrational exuberance in the lending and borrowing market and some problems.

You said that there are a number of things that have come on the market since the North Carolina law was introduced that were really not addressed in the North Carolina law. Would you give us a couple of examples of that and then follow that up with written documentation of what you think needs to be added to the North Carolina law if we were going to try to use the North Carolina law as a Federal standard?

Mr. CALHOUN. Certainly, the primary development has been what I would call the abandonment of traditional underwriting standards. Ten years ago when we talked about predatory lending, the one point of consensus was its so-called asset-based lending, lending against the equity in the home without regard for whether the borrower could actually pay the payments on the loan.

That was the essence of predatory lending is what we have seen as the incremental steps. That's what's developed over the last 4 years and I think there are two important things here. One is that it has been incremental, this payment shock that we have talked

about today. They didn't just start lending with these loans with huge payment shocks. It got worse and worse each quarter.

And the dynamic that's the real concern, when you step back to the 30,000-foot level, is we have a situation.

Mr. WATT. Why don't you address that in writing, because my time has expired.

Chairwoman MALONEY. The gentleman's time has expired. That was an excellent question. The last question will go to Patrick McHenry of North Carolina. And we are called for a vote and this will conclude our hearing.

Mr. MCHENRY. This is a question for the whole panel, so, be prepared. It's going to be very simple and short answers because we don't have much time.

Every three out of four loans in the foreclosure process do not wind up in a foreclosure sale. In 2005, FMAC studied this issue. It was estimated that the average cost of a single foreclosure for the lender averages $58,000. Those are FMAC's numbers.

Could you expand on why, actually, how about this. Very simple, the whole panel will start from left to right here. Yes or no: Is it bad for lenders to lend money to people who are not capable of paying it back? Yes or no, Mr. Calhoun?

Mr. CALHOUN. On an individual level, no. But it is profitable on a macro level, and that's what we have seen here. They'll lose money on an individual loan.

Mr. MCHENRY. Once more, I don't have time for long-winded answers.

Mr. CALHOUN. That's my answer that you heard.

Mr. MCHENRY. Which is "kind of." Okay? Mr. Silver?

Mr. SILVER. You have to send it back to the lender without considering repayment ability. And, if I might, Representative—

Mr. MCHENRY. Yes, that is a good answer. Mr. Fishbein?

Mr. FISHBEIN. Look at the volume of loans handled by consumer rescue funds and you see several examples of failure.

Mr. MCHENRY. Thank you. I don't have time. Mr. Silver? Thank you.

Mr. SILVER. Yes, on an individual basis I would agree with Mr. Calhoun. However, changes in the market allow much higher foreclosure rates and still make profits for lenders than occurred in the past.

Mr. MCHENRY. So, losing money is good? Number four, here. Thank you. I appreciate your answer the most. All right, thank you. Back to Mr. Calhoun. Do you have a lower cost of funds in commercial mortgage subprime mortgage lenders?

Mr. CALHOUN. No, we get most of our funding through Wall Street Repurchase Agreements.

Mr. MCHENRY. So, you don't use community foundation grants or anything like that?

Mr. CALHOUN. We received, as I believe you know, grants to set up the original loan loss reserves for the loans. But, for example, when we securitize loans we sell them on the market and the people who buy them don't care about anything except the finances. And that's what they pay.

Mr. MCHENRY. The insurance policy for the loan loss is based on grants that have been given to your organization?

Mr. CALHOUN. In part, yes.

Mr. MCHENRY. So, yes. You have subsidized lending because you are able to get money for free?

Mr. CALHOUN. It gave us start-up funds but our sustainability has depended upon it being self-sustaining.

Mr. MCHENRY. Okay, thank you. Additionally, I want to thank Mr. Pollock in particular for his one-page mortgage document. I think that's fantastic. I think that this is something the committee should have hearings on and we should move forward on this. At this point, I would like to yield my remaining time to Mr. Price of Georgia.

Mr. PRICE. I thank my colleague from North Carolina for yielding. I appreciate the testimony of all of you presented. I think it points out clearly that we need much greater financial literacy. There appears to be some bipartisan agreement on that and hopefully we will be able to go forward. I am a little troubled by what appears to be a relative disdain for willing lenders and willing borrowers. And I wonder what that says about our general sense about our markets and about our sense of commerce right now in our Nation.

Mr. Calhoun, I heard you say, you cited all sorts of examples about the typical subprime loan and how it leads to troubling results in many areas, and you said that one-sixth of the market are subprime loans. Yet, they comprise two-thirds of the foreclosures in the market. And that implies that there's an ideal number for each of those. Do you have a sense about where that ideal is?

Mr. CALHOUN. No. I think what it reflects more is what one of the members of the previous panels said—when you tease that apart, those foreclosure rates vary dramatically depending upon the loan features and that subprime loans that don't have these abusive features the built-in payment shock have less than half of the foreclosure rate of the loans that do have those abusive features. That's our big concern: get those features out and then let the market decide what's the appropriate balance.

Mr. PRICE. I appreciate that. I have about 30 seconds, I think. I want to commend Mr. Pollock for your comment and perspective that we are late in this cycle and whether or not the Federal Government action will result in anything good to the entire market, I think, is an apt perspective.

And I would ask, and I am not going to have any time it doesn't look like, but I would ask each of you, and we'll give this to you in writing, whether or not you agree that we are late in this cycle and whether or not you believe that Federal Government intervention at this point in this cycle can have any positive result.

Chairwoman MALONEY. The gentleman's time has expired. The Chair notes that some members may have additional questions for the 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 to place the responses in the record.

I want to thank all of the panelists for your testimony today.

Mr. FISHBEIN. Chairwoman Maloney, if I may, I had asked if I could have a letter that has been signed by 80 groups to the regulators inserted in the record?

Chairwoman MALONEY. Yes.
The hearing is now adjourned. Thank you.
[Whereupon, at 1:45 p.m., the hearing was adjourned.]

A P P E N D I X

March 27, 2007

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

SUBPRIME AND PREDATORY LENDING: NEW REGULATORY GUIDANCE, CURRENT MARKET CONDITIONS, AND EFFECTS ON REGULATED INSTITUTIONS

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

March 27, 2007
2128 Rayburn House Office Building

Congresswoman Maloney, Congressman Gillmor and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding subprime mortgage lending products and predatory lending.

Today's hearing focuses on an important topic. We can all agree that there are social and financial benefits to home ownership. Because homeowners have an investment in their community, home ownership promotes neighborhood stability and civic involvement. In addition, for most homeowners, their residence is their most valuable asset. Traditionally, residential real estate has been a sound, stable investment providing a means to build wealth. Government policies, ranging from tax incentives to the formation of government sponsored enterprises, have long encouraged home ownership.

In recent years, many consumers took advantage of low interest rates and new mortgage products to push the home ownership rate to almost 69 percent. Product innovation and the expansion of mortgage credit have been generally positive social developments. Yet, for a significant segment of the subprime market, we have seen a troubling trend. Many of these borrowers have accumulated debt obligations that put their financial health at risk even after years of positive economic growth. Subprime borrowers spend nearly 37 percent of their after-tax income on mortgage payments and other costs of housing – roughly 20 percentage points more than prime borrowers spend,

and 10 percentage points more than subprime borrowers paid in 2000.[1] The obligations of subprime borrowers with adjustable rate mortgages (ARMs) are likely to increase further as rates reset. Of ARMs originated in 2006, a full 24 percent have negative home equity.[2]

To be sure, many subprime borrowers have benefited from the expansion of mortgage credit. However, rather than building wealth, many other borrowers are struggling to keep their homes. Many subprime borrowers have little financial cushion in the event of personal emergencies or economic downturns. In addition, many subprime borrowers have been the targets of practices that are highly troubling, if not predatory. Repeat refinancings have taken equity from their homes and adjustable rate features have challenged their ability to continue making payments. In previous years, many of these borrowers could have refinanced their mortgages or sold their homes at a profit to repay their debt in full. Now, as home prices have stagnated or even declined in many areas of the country, more borrowers find themselves trapped in mortgages they cannot afford to pay. Abusive lending practices that result in home ownership that builds debt rather than wealth harm not only individual consumers, but undermine the important societal benefits of home ownership.

My testimony today will discuss recent practices in the mortgage market that have raised concerns at the FDIC, especially with regard to subprime lending. I also will review actions the FDIC has taken to address issues in the subprime market, including the

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[1] Eduardo Porter and Vikas Bajaj, "Mortgage Trouble Clouds Homeownership Dream," *New York Times*, March 17, 2007.
[2] First American CoreLogic, *Mortgage Payment Reset*, March 19, 2007, p. 11

proposed statement on subprime lending. Finally, I will articulate some of the options and challenges we see as Congress considers further steps to address predatory practices. We believe that the time has come for national anti-predatory lending standards applicable to all mortgage lenders, including nonbanks as well as banks.

Clear, common sense standards regarding the underwriting and marketing of subprime adjustable mortgages will reinforce market discipline and preserve an adequate flow of capital to fund responsible lending. It will be important for regulators and Congress not to overreact in developing the standards. Overly rigid rules or introduction of unfamiliar new concepts could create heightened uncertainty and confusion in the market.

Contrasting Subprime Lending and Predatory Lending

Subprime lending involves providing credit to individuals and households with poor or limited credit histories who pose a higher risk of default and foreclosure. The FDIC recognizes the value and benefits of responsibly underwritten loans to consumers with less than perfect credit profiles, provided that institutions have the necessary expertise and capital support to manage them in a safe and sound manner. This does not mean, however, that lenders should make loans that borrowers will inevitably have difficulty repaying, or impose terms that will exacerbate borrowers' credit problems.

While some of the leading originators of subprime loans are banks and thrifts (or their subsidiaries or affiliates) these loans also are offered by thousands of independent mortgage lenders not regulated by the financial institution regulatory agencies. Because of their higher risk, subprime loans carry higher interest rates and, until recent years, more stringent collateral requirements and other risk mitigants.

There is no universally accepted definition of predatory lending. Determining whether a subprime loan product is predatory involves looking at both the loan and the borrower -- and, typically, the whole course of the transaction. Products that may be appropriate for one type of borrower in a particular circumstance may be inappropriate under different facts or circumstances.

In 2001, the financial institution regulatory agencies identified the characteristics most often associated with predatory lending:[3]

- Making unaffordable loans based on the collateral of the borrower rather than on the borrower's ability to repay an obligation;
- Inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); and
- Engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

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[3] *Expanded Guidance for Evaluating Subprime Lending Programs*, FIL-9-2001, January 31, 2001, http://www.fdic.gov/news/news/financial/2001/fil0109.html.

Predatory lending can impose significant financial harm on consumers. Rather than providing an opportunity for building individual or family wealth, predatory lending extracts wealth from consumers, and can severely impact their future financial prospects. In addition to being extremely damaging to consumers, predatory lending is inherently an unsafe and unsound banking practice. Thus, the FDIC has a vested interest in ensuring that predatory lending practices do not take root in the banking system.

Overview of the Subprime Mortgage Market

A number of factors, including intense lender competition, historically low interest rates, rapid home price appreciation, and, crucially, investor demand for mortgage paper, facilitated the dramatic growth in the subprime market between 2003 and 2005. After many prime borrowers obtained loans during the refinance boom of 2003, mortgage originators struggled to maintain or increase market share in the declining origination market. Many of these lenders operated large origination platforms that needed mortgage paper to remain viable. Borrowers with blemished credit histories, many of whom were not able to obtain financing during the refinance boom, began to represent a larger portion of potential customers. As a result, the subprime share of all mortgage loan originations jumped from 7.9 percent in 2003 to 20 percent in 2005.[4] As

[4] *Inside Mortgage Finance*, December 1, 2006.

of third quarter 2006, subprime mortgages accounted for approximately 12.8 percent of all mortgage debt outstanding.[5]

Some mortgage originators offered new types of mortgage products that were specifically designed to attract borrowers with low initial rates. These "affordable" payments would then reset to carry above market interest rates for the remainder of the loan term. The reset trigger was usually after one or two years, although some loans reset after as little as one payment. These types of loans were simultaneously attractive both to borrowers, who could obtain larger loans at lower cost for at least a short time, and to investors in mortgage loan pools, who were attracted to the above-market yields possible following the reset period. Lenders expanded the use of nontraditional mortgage products -- interest-only mortgage loans[6] and payment-option ARMs[7] to prime borrowers -- and began offering new hybrid ARMs, such as the so-called "2/28" or "3/27" mortgage loans[8] to subprime borrowers.

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[5] FDIC-derived estimate based on third quarter 2006 data from *Mortgage Market Update* and the Federal Reserve Board's Flow of Funds data.

[6] Interest-only mortgages are loans for which the borrower is required to pay only the interest due for a specified number of years (e.g., three or five years). After the interest-only period, payments include both principal and interest sufficient to amortize the debt. During both the interest-only period and the amortizing period, the interest rate may be fixed or may fluctuate based a prescribed index. The financial institution regulatory agencies consider interest-only mortgages to be non-traditional mortgages.

[7] Payment-option ARMs are mortgages that allow the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a "start" or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term. The financial institution regulatory agencies consider payment option ARMs to be non-traditional mortgages.

[8] 2/28s and 3/27s are hybrid ARMs typically marketed to subprime borrowers. These ARMs are similar to ARMs that are prevalent in the prime market (known as 3/1 ARMs), in that they have a fixed rate for 2/3 years and then adjust to a variable rate for the remaining 28/27 years. However, the spread between the initial fixed rate of interest and the fully-indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points on 2/28 and 3/27s, versus 100-250 basis points on prime 3/1 ARMs.

Prior to 2000, the majority of subprime mortgages were fixed rate loans. But during the first half of this decade, as intense competition led lenders to seek out less qualified borrowers, there was a transformation in the subprime market toward more complex products that can have a combination of risk factors, such as increasing debt-to-income (DTI) ratios, minimal documentation, and high loan-to-value ratios. In 2006, almost three-quarters of non-agency securitized subprime mortgage originations were adjustable rate mortgages, primarily 2/28 and 3/27 hybrid loans.[9] Estimates are that at least 2.1 million subprime hybrid ARMs are outstanding today.[10] This would mean that approximately 1.7 percent of U.S. households have 2/28 or 3/27 loans.

In addition, the low- or no-documentation share of subprime lending has grown significantly since 2001, from about 25 percent to over 40 percent. Furthermore, prepayment penalties are more prevalent among subprime loans than among Alt-A[11] or prime mortgages. In 2006, 68 percent of subprime mortgages included in non-ageney securitizations had prepayment penalties, compared to 51 percent of Alt-A loans and only 1.5 percent of prime mortgages.[12] Finally, average loan-to-value ratios for both fixed and adjustable rate subprime loans have increased.

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[9] Source: LoanPerformance database of nonprime (subprime and Alt-A), non-agency securitized mortgage originations.
[10] Source: LoanPerformance database of nonprime (subprime and Alt-A), non-agency securitized mortgage originations.
[11] Alt-A loans are those made under expanded underwriting guidelines to borrowers with marginal to very good credit. Alt-A loans are riskier than prime loans due to the underwriting standards of the loans, not necessarily the credit quality of the borrowers.
[12] Source: LoanPerformance databases of prime and nonprime (subprime and Alt-A), non-agency securitized mortgage originations.

Consumer Protection Concerns

As the Committee is well aware, poorly underwritten or predatory lending carries with it a number of significant consumer protection concerns.

Disproportionate Impact on the Financially Vulnerable

While it is not possible to directly measure the demographic characteristics of subprime hybrid ARM borrowers, the 2005 Home Mortgage Disclosure Act (HMDA) data indicate that higher priced loans are disproportionately made to minorities and lower income households. As you know, the HMDA data do not contain all the information needed to ascertain whether a higher-priced loan is a predatory loan. For example, the HMDA data do not identify nontraditional loans, or even whether a loan has a variable rate. Nonetheless, the fact that African-Americans were three times more likely than non-Hispanic Whites to receive higher-priced home purchase loans during 2005 and evidence that minorities disproportionately borrow from higher-priced lenders[13] raise concerns about fair access to home mortgage loans.

Misaligned Interests of Borrower, Broker, Lender and Investor

Reputable mortgage brokers can be a tremendous help to borrowers, offering them access to options they have difficulty finding on their own. However, mortgage brokers generally do not have a duty to find the most appropriate loan for a borrower, and they are not directly compensated based on benefits to the borrower. Moreover,

[13] *Higher-Priced Home Lending and the 2005 HMDA Data, Federal Reserve Bulletin*, Table 13A. Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, September 2006.

mortgage brokers have no financial risk if the loan eventually defaults because they are compensated by lenders who in turn offer incentives based on the lender's preference for products it wishes to hold or sell. For example, a broker compensated with yield spread premiums (YSPs) -- the difference between the par rate for a loan (the minimum acceptable interest rate) and the interest rate actually paid by the borrower -- has an incentive to encourage a borrower to take a product with a higher interest rate.

Lenders that retain the mortgages they originate have interests more aligned with those of borrowers in the products offered and in the structuring of loans, because they bear a substantial financial risk if the borrower defaults. However, in the case of loans sold on the secondary market, as I will explain in more detail later, the lender's preferences are heavily influenced by what market investors want to buy, which may not match what is appropriate for the borrower.

Aggressive and Misleading Marketing

Aggressive or misleading marketing can have a negative impact on the ability of borrowers to make informed credit decisions. Marketing that promises the ability to "Buy more house!" or "Repair your credit!" often obscures critical features of the loan product. Without countervailing information, consumers may not realize that they may be unlikely to afford the required monthly payments -- particularly when a loan includes an initial teaser interest rate that will expire. In addition, because negative information can be part of consumer credit records for seven to ten years, consumers may not realize

that repairing their credit may take much longer than the marketing promises,[14] and that positive performance on one loan will not materially improve their credit standing if they fail to repay other loans on time.

To demonstrate the impact on subprime borrowers, Table 1 illustrates the results from a February 12, 2007, publicly-available rate sheet from a typical large-volume subprime lender. A borrower with $38,000 in gross income and a 620 Fair Isaac and Company (FICO) risk score could obtain a $200,000 stated income, 2/28 hybrid ARM. With the loan's introductory fixed interest rate of 8.30 percent, the borrower would have a monthly principal and interest payment of $1,510 for the first two years based on a 30-year amortization period. The borrower's DTI ratio is 48 percent, so the monthly mortgage payment would represent approximately half of the borrower's monthly gross income. Real estate taxes and property insurance would add to this debt burden.

After the initial fixed rate period, the variable interest rate would be the six-month London Interbank Offered Rate (LIBOR), which is 5.375 percent at origination, plus 6.99 percent. The interest rate would begin to rise, initially by 3 percent, and then a 1.5 percent increase every six months until the fully-indexed rate or the lifetime interest rate cap is reached. Thus, the fully-indexed rate at the time of loan origination (12.365 percent) would result in a monthly principal and interest payment of $2,092, representing two-thirds of the borrower's monthly gross income (66 percent DTI ratio). The

[14] See 15 U.S.C. 1681(c) – provisions of Fair Credit Reporting Act that permit adverse information to be included in credit reports for seven years and bankruptcy information to be included for ten years.

underlying index rate would be subject to change and could further increase the monthly payment amount and DTI ratio.

From this same lender, published rate sheets suggest that the borrower could have received a stated income, 30-year fixed rate mortgage with an interest rate of 8.80 percent (8.30 percent + 0.50 percent adjustment for fixed rate option).[15] The monthly principal and interest payment for this mortgage loan would be $1,581, resulting in a DTI ratio of 50 percent. Although the borrower would have had to pay $71 more each month, the borrower's payment would be fixed for thirty years with no risk of payment shock. Furthermore, if the borrower could fully document his/her income, the interest rate would have been lower than even the start rate of the 2/28 product.[16] This suggests that many borrowers who opt for this product today either do not understand or are not being told the other options available to them -- or they cannot afford an additional $71 per month for a fixed-rate product, which indicates a severe affordability problem at the 2/28 loan's inception.

[15] The interest rate information is based on publicly-available rate sheets from a large volume subprime lender as of February 12, 2007.
[16] The interest rate is 8.10 percent, which is based on the introductory fixed interest rate for a fully-documented 2/28 loan of 7.60 percent plus 0.50 percent adjustment for fixed rate option.

Table 1. Comparison of Mortgage Products			
Product Type	**"2/28" Hybrid ARM (Stated Income)**	**30-year Fixed Rate (Stated Income)**	**30-year Fixed Rate (Full Documentation)**
Balance at origination	$200,000	$200,000	$200,000
Interest rate for Year 1 & 2	8.30%	8.80%	8.10%
Payment for Year 1 & 2	$1,510	$1,581	$1,482
DTI ratio for Year 1 & 2	48%	50%	47%
Interest rate for Year 3	11.25%	8.80%	8.10%
Payment for Year 3	$1,928	$1,581	$1,482
DTI ratio for Year 3	61%	50%	47%
Interest rate for Year 4	12.365%	8.80%	8.10%
Payment for Year 4	$2,092	$1,581	$1,482
DTI ratio for Year 4	66%	50%	47%

Safety and Soundness Concerns

In addition to being potentially harmful to borrowers, the current conditions in the subprime mortgage market may pose unacceptable risks to both insured institution and non-bank lenders.

Loosened Underwriting Standards

As investor appetite for more volume and competitive pressures increased in the mortgage market, many lenders loosened their underwriting standards in both the prime and subprime markets. Many of these products required little or no documentation of income or were accompanied by practices such as simultaneous second-lien mortgages that create additional layers of risk for lenders. Reduced documentation increases the risk of loss since institutions are essentially relying on assumptions and unverifiable information to analyze the borrower's repayment capacity. Simultaneous second-lien

mortgages ("piggybacks") were designed to circumvent requirements for private mortgage insurance (PMI), which is expensive for the borrower but mitigates the lender's risk in a higher loan-to-value mortgage. However, such structures serve to reduce a borrower's up-front equity in the home and increase monthly debt service, without any corresponding risk mitigation for the lender. When one loan combines several such features, the total risk is compounded.

The industry also has relied increasingly on the use of risk-based pricing, often generated by sophisticated proprietary models, as an underwriting alternative to verifying the borrower's income or collateral protection. The premise of risk-based pricing is to build an additional loss cushion into the price of the credit product to cover the incremental loan losses and overhead costs related to underwriting, servicing and collecting a portfolio of loans. However, a higher interest rate does not improve the credit quality of a higher-risk loan. While such models have been reasonably successful in the prime market, the logic underlying such modeling breaks down as the baseline price of the product increases. In fact, recent experience has shown that the predictive nature of subprime models can be unreliable.[17]

For subprime and Alt-A loans, early payment defaults appear to be much more prevalent in low documentation loans than in mortgages that required full documentation. Available data do not include early payment defaults that have been returned from securitization trusts to the originators. However, it is possible to estimate the frequency

[17] See *Wall Street Journal* article, "Faulty Assumptions: In Home-Lending Push, Banks Misjudge Risk – HSBC Borrowers Fall Behind on Payment; Hiring More Collectors," February 8, 2007

of early payment defaults by examining the percentage of loans remaining in pools and in default four months after origination. Among Alt-A non-agency securitized loans used to purchase a home in 2006, 1.09 percent of low-documentation loans defaulted within the first four months – about twice as many as loans that required full documentation (0.56 percent). Among similar subprime mortgages, 4.67 percent of low documentation loans defaulted within four months, while only 3.14 percent of full documentation loans defaulted.[18]

Securitizations

Some financial institutions seek to manage the risks associated with nontraditional and subprime mortgage products by securitizing their mortgage originations and spreading the risks of these products to investors. In fact, the share of U.S. mortgage debt held by private mortgage-backed securitizations doubled between 2003 and 2005, helping to fuel the growth of subprime and nontraditional mortgages. The ability to securitize pools of such mortgages certainly helped to make these loans available to borrowers through both FDIC-insured institutions and through mortgage brokers. Although securitization can spread the credit risks associated with these mortgages to investors, such a strategy may not mitigate the risks caused by poor controls over underwriting or the lack of adherence to representations and warranties made to the investors.

Subprime loans have largely been originated for sale into the secondary market, where they are pooled into securitizations and known as collateralized mortgage

[18] Source: LoanPerformance database of nonprime (subprime and Alt-A), non-agency securitized mortgage originations.

obligations (CMOs) or asset backed securities (ABS). Traditional structures of these types, such as real estate investment conduits (REMICs), formerly contained prime loans. Subprime securitizations have increasingly adopted a senior/subordinate structure, where the originating or issuing bank may keep the first-loss piece or tranche of the CMO or ABS after selling the more highly-rated tranches to investors. In some instances, ABS tranches find their way into more complex capital market instruments called collateralized debt obligations (CDOs), which carve up credit risk in ways that are often difficult for the average market participant to comprehend. Securitizing pools of loans in this manner also raises additional risks including liquidity risk and market risk – especially when demand for securitization paper backed by loans intended for immediate sale unexpectedly dries up, forcing the originator to secure long-term funding for these assets.

Further, risks to banks originating prime loans for securitization and acting as seller/servicer, such as defaults and fraudulent documentation, are heightened for subprime loans because of the "easy credit" design of loans frequently marketed to subprime borrowers. The same representation and warranty clauses that allow prime loan investors to put back loans to the originating institution if they fail to meet certain standards are written into subprime securitizations as well. Because these repurchase or replacement demands are typically triggered by borrower delinquency, subprime securitizations are likely to suffer a higher level of put-backs to the originating institution. In addition to put-backs, some banks could suffer liquidity consequences through "triggers" or covenants in securitization or warehouse lien documents. If a loan pool

does not perform as desired or if the institution's own financial condition declines, bondholders can sometimes demand replacement loans, higher fees or interest -- or in extreme cases, can even stop providing funding to originating institutions.

In addition, representation and warranty clauses can be extensive in some deals, going beyond the typical error, omission, misrepresentation and fraud conditions, to require the seller to attest that the debt to income ratio on all loans must not be greater than 60 percent at origination. For securitizations backed by low document, no document, and stated income loans, such representations and warranties can provide the investors with plenty of leeway for putting delinquent loans back to the servicer. While representations and warranties serve as a critical safeguard to investors against fraud and misrepresentation, an over-reliance on these provisions could limit the actual amount of credit risk transferred from the seller of assets to the investors -- investors who, in return for the yield earned on the security, are expected to perform an appropriate amount of due diligence prior to purchase.

Banking regulators grant a significant amount of capital relief to securitizations with the expectation that such vehicles transfer credit risk to the capital markets. Banks that are required to repurchase assets under representation and warranty provisions and early default clauses are exposed to an elevated degree of credit risk associated with these often delinquent assets as well as the liquidity risk associated with having to secure immediate funding on these assets. In situations where the regulators determine that certain representations and warranties are too permissive and potentially expose the

selling bank to a high amount of loss, additional capital requirements may be considered. A similar review and evaluation of the nature and structure of representations and warranties beyond the banking industry might serve as a useful tool in encouraging the investor community to more closely monitor the underlying assets in ABS structures.

Credit Risk

Although subprime hybrid ARMs are typically marketed as "affordability products," they actually create a payment shock problem when the loan resets and the monthly payment increases. Payment shock is especially serious when lenders qualify subprime borrowers at the lower fixed introductory or teaser rate of interest rather than the fully-indexed interest rate, assuming a fully-amortizing repayment schedule. As the earlier example in Table 1 demonstrates, the increase in monthly payments can be substantial. Lenders that do not qualify borrowers at the fully-indexed interest rate are not appropriately evaluating the ability of borrowers to repay their loans, resulting in possible losses for both lenders and borrowers.

The FDIC is concerned that the subprime borrowers who have taken these loans will face an array of serious problems. They may be unable to afford their monthly payments after the initial rate adjustment, or after subsequent adjustments that occur as often as every six months. Borrowers with limited financial resources often have no choice other than to refinance their loan and incur expensive refinancing fees due to closing costs and prepayment penalties. If refinancing is impossible, delinquencies and other adverse credit indicators are often the result.

Delinquency and Foreclosure Trends

On the whole, mortgage delinquencies and foreclosures fell to historic lows from 2003 through 2005, primarily due to low interest rates and strong levels of home price appreciation that fueled growth in mortgages. As growth has slowed, delinquency and foreclosure rates have increased, but currently remain below the peaks seen after the 2001 recession.

The past due rate on one-to-four family residential mortgages, overall, for the fourth quarter of 2006 was 4.95 percent, up from 4.7 percent a year ago. However, the rate for subprime mortgages is much higher. The past due rate for all subprime mortgages is 13.33 percent, and the rate for subprime ARMs is 14.44 percent.[19] It is estimated that the $1.28 trillion in total subprime mortgages represent 12.8 percent of all mortgages outstanding.[20]

Nationwide, foreclosures started on subprime ARMs were 2.7 percent of loans outstanding in the fourth quarter of 2006. That figure is approaching the levels reached just before the 2001 recession, and is more than double the recent low of 1.3 percent in mid-2004.[21] Data on securitized loans indicate that recently originated subprime hybrid mortgages are performing worse than those originated in prior years. Over 10 percent of

[19]Mortgage Bankers Association *National Delinquency Survey* via Haver Analytics. Numbers are seasonally adjusted.
[20] FDIC-derived estimate based on third quarter 2006 data from *Mortgage Market Update* and the Federal Reserve Board's Flow of Funds data.
[21] Mortgage Bankers Association *National Delinquency Survey* via Haver Analytics. Numbers are seasonally adjusted.

non-agency, securitized, subprime hybrid loans originated in 2006 became seriously delinquent or started foreclosure within 11 months of origination. After the same 11 month period of seasoning, only 5.5 percent of similar loans originated in 2005 were performing as badly.[22]

The highest rates of foreclosure among subprime adjustable rate borrowers are currently found in states that have experienced the slowest rates of home price appreciation over the past year. For example, new foreclosures on subprime ARMs were up sharply in Michigan and Ohio, where local economic conditions have been weak in recent years. These are also areas experiencing home price depreciation, which makes it difficult for borrowers to refinance their loans when rates reset. However, subprime ARMs are also showing increased stress, although not as great, in states such as California that have previously benefited from very rapid home price gains and generally good economic performance but where home price appreciation is now slowing.

Until early this year, investors searching for higher yields provided ample cash to the mortgage industry. However, rising defaults have curbed investors' appetite for securities backed by subprime mortgages, making it hard for subprime lenders to sell their loans and raise cash to make new ones. Several non-bank private subprime lenders have already filed for bankruptcy protection after having their financing cut by the banks and brokerage firms that were facilitating the securitization of their subprime mortgages. The risk premium demanded by investors in subprime mortgage paper has increased

[22] Source: LoanPerformance database of nonprime (subprime and Alt-A), non-agency securitized mortgage originations

dramatically in recent weeks, weakening the business model of the stand-alone subprime originators.

Response to Lending Practices

Supervisory Statements and Guidance

The FDIC and the other federal financial institution regulatory agencies (collectively, the Agencies) strive to remain abreast of innovations in the marketplace and consider their implications from both a safety and soundness and a consumer protection perspective. For example, in September 2006 the Agencies issued *Interagency Guidance on Nontraditional Mortgage Product Risks (*NTM Guidance) in order to address concerns about offering interest-only and payment-option ARMs to borrowers for whom they were not originally designed.[23] The NTM Guidance not only reminded bankers to carefully manage the risks associated with these products, it also emphasized that consumers should be provided with clear and accurate information about these products at the time they are choosing a loan or deciding which payment option to select. FDIC examiners evaluate an institution's processes, policies, and procedures to ensure that its practices appropriately address the risk of these products. To help the industry provide necessary information to borrowers, the federal banking agencies proposed model illustrations that institutions may use to assist consumers as they select products or choose payment options.[24]

[23] See *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 FR 58609 (October 4, 2006).
[24] See *Proposed Illustrations for Nontraditional Mortgage Products*, 71 FR 58672 (October 4, 2006).

Subsequently, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) distributed guidance to state agencies that regulate residential mortgage brokers and companies on the risks posed by nontraditional mortgage products. The CSBS/AARMR guidance substantially mirrors the federal nontraditional mortgage guidance, applying the sections that address non-depository institutions. To date, 26 states and the District of Columbia have adopted the CSBS/AARMR guidance.

On January 22, 2007, the FDIC issued its *Supervisory Policy on Predatory Lending*[25] that describes certain characteristics of predatory lending and reaffirms that such activities are inconsistent with safe and sound lending and undermine individual, family, and community economic well-being. The policy also describes the FDIC's supervisory response to predatory lending, including a list of policies and procedures that relate to consumer lending standards.

Since the subprime market raises additional concerns,[26] the federal banking agencies issued a *Proposed Statement on Subprime Mortgage Lending* on March 2, 2007 (the Statement).[27] The Statement emphasizes that lenders must not allow their mortgage programs to become predatory. As the Statement explains, institutions marketing mortgage loans with predatory characteristics carry an elevated risk that their conduct

[25] See FDIC Financial Institution Letter 6-2007, dated January 22, 2007.
[26] The NTM Guidance focused on the risk of products that defer the repayment of principal and sometimes interest. Since 2/28 and 3/27 hybrid ARMs are fully-amortizing, these products did not meet the definition of nontraditional mortgages in the NTM Guidance.
[27] See *Proposed Statement on Subprime Mortgage Lending*, 72 FR 10533 (March 8, 2007).

will violate the Federal Trade Commission (FTC) Act's prohibition against unfair and deceptive practices, which the FDIC and other agencies enforce.[28]

The Statement makes clear that lenders should follow two fundamental consumer protection principles when underwriting and marketing mortgages. First, a loan should be approved based on a borrower's ability to repay it according to its terms (not just at the initial rate, for example). Second, borrowers should be provided with the information necessary to understand a transaction at a time that will help them decide if the loan is appropriate for their needs. The Statement cautions that such communications should not be used to steer consumers to these products to the exclusion of other institution products for which consumers may qualify. Relying on these principles, lenders will be able to offer mortgages that meet the needs of most subprime customers in a safe and sound manner. We look forward to receiving comment on the Statement and will carefully review the commenters' views.

CSBS and AARMR also have strongly endorsed the Statement. They are particularly interested in comments regarding the applicability of the Statement to state-licensed and supervised residential mortgage brokers and companies. CSBS and AARMR intend to develop a parallel statement for state supervisors to use with state-supervised entities.[29]

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[28] See Joint Board and FDIC *Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks*, issued through FDIC Financial Institution Letter 26-2004 dated March 11, 2004.
[29] Refer to CSBS and AARMR media release dated March 2, 2007.

Examination and Supervisory Actions

The FDIC also aggressively addresses predatory lending through examinations and supervisory actions. When examiners encounter loans with predatory characteristics, the FDIC takes whatever supervisory actions are necessary to effect correction. When the FDIC finds practices that violate consumer protection, fair lending and other laws, including the FTC Act prohibition against unfair or deceptive practices, we take action to ensure that illegal practices cease and that harm to consumers is remedied.

The FDIC also has worked to integrate the new HMDA pricing data into its fair lending compliance examination program. Compliance examiners are now required to evaluate racial and gender-related patterns in the HMDA pricing data when conducting compliance examinations of all institutions subject to HMDA reporting requirements. The FDIC also uses the new HMDA pricing data to identify outlier institutions that warrant special scrutiny because of larger pricing disparities for minorities or females in one or more loan product areas than are evident for other FDIC-supervised institutions. Institutions identified as outliers are asked to provide the FDIC with information that explains the channels through which people obtain mortgage loans and the factors the bank considers in making its pricing decisions for the loan product under review. As necessary, comparative analysis is conducted to determine whether those factors were fairly and neutrally applied. In addition, the FDIC considers whether minorities or women have been disproportionately steered to high cost products.

Examinations at a handful of the outlier institutions suggest the possibility of discriminatory pricing on the basis of race. In these situations, loan officers typically

enjoyed broad, unmonitored pricing discretion. Although the work of the FDIC in this area is ongoing, we have referred two of these matters to the Department of Justice for enforcement action. In addition, credit practices that are discriminatory, unfair and deceptive, involve unearned fees or kickbacks, or fail to meet other significant regulatory standards weigh against an institution when its Community Reinvestment Act (CRA) performance is assessed.[30]

The FDIC also helps financial institutions meet the credit needs of their entire communities, including low- and moderate-income areas by conducting outreach and providing technical assistance to banks and community organizations to foster community economic investment and fair lending. Because well-informed consumers are less likely to be the victims of predatory lenders and are more likely to make informed choices, the FDIC disseminates free consumer information in a variety of forms. For example, the FDIC's Money Smart Financial Education program is widely used to help adults outside the financial mainstream enhance their money management skills and create beneficial banking relationships. When a bank's CRA performance is reviewed, the institution's efforts to provide financial education and other retail services are given positive consideration.

Options/Challenges for Reform

Widespread credit distress in the subprime mortgage market, with especially pronounced problems among independent mortgage lenders, suggest the need for a

[30] See 12. C.F.R. §345.28(c).

comprehensive response that assures that all lenders are subject to certain baseline requirements. Guidelines and other supervisory standards promulgated by federal bank regulators apply to only a portion of the market. Moreover, the lack of uniform standards creates negative competitive pressures on insured institutions. A national anti-predatory lending standard would help assure basic uniform protections for all borrowers, as well as create a more level competitive playing field for regulated entities. There are two possible approaches to create and implement an anti-predatory lending standard that would apply across the mortgage lending industry.

First, Congress could articulate a set of anti-predatory lending standards in a statute. A statutory approach to establishing a national anti-predatory lending standard could draw from our current and proposed federal regulatory guidelines, as well as existing state anti-predatory lending statutes. It should raise the bar by strengthening protections available to borrowers. At its core, it should address at least two important areas: 1) the ability of the borrower to repay the loan and 2) misleading marketing and disclosures that prevent borrowers from fully understanding the terms of loan products.

A statutory national predatory lending standard should require underwriting based on the borrower's ability to repay the true cost of the loan, not payments based on an artificially low introductory rate. This requirement would go a long way toward helping borrowers avoid loans that they cannot repay, and would improve the quality of lender portfolios and mortgage backed securities. It also would help balance the role of

mortgage brokers by curtailing the incentives to steer customers to high cost products that they cannot afford.

A national anti-predatory lending standard should also address misleading or confusing marketing that prevents borrowers from properly evaluating loan products. Marketing materials are often crafted to induce even cautious borrowers into inappropriate products. One key area of concern is the misuse of the word "fixed" to describe negative amortization products where the rate adjusts though the payment may be "fixed" for a certain period. The term can also be used misleadingly to describe hybrid ARMs where the rate is fixed only for the first few years. In addition, as previously mentioned, some lenders and brokers disclose information about comparably priced 30 year fixed rate mortgages less prominently than more lucrative exotic products with payment shock features.

A national predatory lending standard could require that rate and payment marketing information for nontraditional mortgages or hybrid ARMs include a benchmark comparison of the rate and payment being offered by the same lender for a 30 year fixed rate mortgage. The standard also could require that all rate and payment disclosure information include full disclosure of the borrower's monthly payment at the fully amortized, fully indexed rate, not just the teaser rate -- consistent with the approach of the NTM guidance and the proposed guidance on subprime lending.

Additional provisions for a national anti-predatory lending standard can be found in among the 36 state anti-predatory mortgage laws currently in effect. This menu of state laws include provisions addressing loan flipping, prepayment penalties, escrow of taxes and insurance, the fiduciary obligations of mortgage brokers, and many other areas. States have proven to be innovative laboratories for the development of consumer protections in recent years, especially in the area of predatory lending. Congress should draw from their experience in drafting national standards.

Alternatively, or in conjunction with a statutory process, the Federal Reserve Board (FRB) could exercise rulemaking authorities it has under the Home Ownership Equity Protection Act (HOEPA) to address abusive practices by all mortgage lenders, not just practices that relate to high cost loans. We understand that the FRB is in the midst of reviewing the regulations that implement HOEPA. The FDIC would strongly support the FRB should it decide to make greater use of the authorities provided by HOEPA to address predatory practices. Many abuses might be more effectively addressed by regulation rather than statute, especially in areas such as misleading marketing, in which the manner and types of abuse frequently change.

The Immediate Problem of Loan Restructuring

National standards will help protect future borrowers. However, the task at hand is to find ways to help borrowers currently in financial distress. Many lenders, loan servicers, and other participants in the mortgage market are currently working with stressed borrowers to restructure their loans or find other ways to allow them to keep

their home and make more affordable payments. The FDIC understands that regulators can play a role in working with all market participants to explore ways to help troubled borrowers. I am pleased to inform the Subcommittee that the FDIC will jointly host a forum on these issues April 16th along with the Office of Thrift Supervision, the Office of the Comptroller of the Currency and the FRB. The forum will include lenders, servicers and other participants in the subprime market to develop alternatives to foreclosure and consider strategies to implement those alternatives. We look forward to comprehensive discussions and creative approaches at this meeting.

Conclusion

In conclusion, the FDIC recognizes the importance of subprime lending if it is properly underwritten and borrowers are provided with complete and understandable disclosures. However, recent practices in the subprime mortgage markets have often placed borrowers in products that create financial hardship rather than building wealth. The FDIC is committed to finding solutions for borrowers already trapped in mortgages they cannot afford. We look forward to working closely with this Subcommittee to address the many issues raised by recent developments in the subprime mortgage market and look forward to the comments we hope to receive from all sectors on the recent proposed Subprime Statement and the discussions we hope to have at our upcoming forum. This concludes my statement. I will be happy to answer any questions the Committee might have.

Embargoed until
March 27, 2007, at 10:00 am

Statement of

John M. Reich, Director
Office of Thrift Supervision

concerning

Subprime and Predatory Lending

before the

Subcommittee on Financial Institutions and Consumer Credit
of the Committee on Financial Services
United States House of Representatives

March 27, 2007

Office of Thrift Supervision
Department of the Treasury

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Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

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John M. Reich, Director
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I. Introduction

Good morning, Madame Chair, Ranking Member Gillmor, and Members of the Subcommittee. Thank you for the opportunity to present the views of the Office of Thrift Supervision (OTS) on current issues related to subprime and predatory lending.

In your invitation letter, Madame Chair, you ask us to address the focus of the recently proposed interagency guidance on subprime hybrid adjustable rate mortgages (ARMs), including the current problems that it is intended to address, our expectations with the proposed guidance, and the need for legislation to address problems in the subprime market. In addition, you inquire about whether the proposed guidance balances efforts to correct abusive lending practices with the need to preserve safe and sound extensions of credit to subprime borrowers. Finally, you ask us to address potential safety and soundness concerns with the subprime lending activities of the institutions we regulate.

In my statement, today, I will attempt to address each of these issues and discuss our overall regulatory regime with respect to the oversight of subprime hybrid ARMs and OTS efforts to combat predatory lending. I will first highlight the relevant data and provide for your consideration some perceptions that have framed the debate on these issues. Next, I will discuss the background and development of the proposed subprime guidance and provide greater detail on the proposal, including what we hope to learn from the comment process.

I will then highlight particular issues with subprime hybrid ARMs with respect to the impact of these products in the current housing market and recently rising foreclosure rates. Finally, I will conclude my statement with a discussion of predatory lending issues and OTS efforts to combat the problem, including various consumer awareness and financial literacy initiatives.

II. Current Industry Data

Recent data suggest that approximately 69 percent of all U.S. households are homeowners. This is up relatively significantly the last five to six years from the historical average homeownership rate of 64 percent. The total U.S. home mortgage debt is $10 trillion. Of this, subprime mortgages account for a total of $1.3 trillion, or roughly 13 percent of aggregate outstanding mortgage debt. In 2005, subprime originations were approximately $600 billion, representing roughly 20 percent of the $3 trillion mortgage origination market that year.

Insured depository institutions, including banks, thrifts, and credit unions, currently hold 32 percent of the approximately $10 trillion of outstanding mortgage debt in the U.S. Government sponsored enterprises (GSEs) and GSE Mortgage Pools hold another 41 percent (down from 52 percent 3 years ago) of aggregate U.S. mortgage debt. Finally, more than 17 percent of mortgage debt is currently held by private asset-backed security issuers, including numerous foreign investors.

With respect to the subprime market, hybrid ARMS are the predominant mortgage product. In fact, 2/28 hybrid ARMs are almost exclusively underwritten to the subprime market. Currently available data indicate that 43 percent of outstanding 2/28 hybrid ARMs were purchase money loans (with 25 percent to first time buyers); 49 percent of these ARMs were cash out refinances; and 8 percent were no-cash out refinances.

We also know that subprime hybrid ARMs typically have significant prepayment speeds, as demonstrated by the following trends:

- 10.5 percent of 2003 subprime hybrid ARM originations are still active;
- 27.5 percent of 2004 originations of these products are still active; and
- 65.3 percent of 2005 originations of these products are currently active.

Approximately $567 billion of subprime ARMs are scheduled for reset in 2007. While this in itself is concerning, we also know that subprime hybrid ARMs are having increased problems well before the rate reset, as demonstrated below:

- Of total 2005 originations, 8.6 percent are seriously delinquent at the 11-month mark;
- Of total 2004 originations, 6.2 percent are seriously delinquent at the 11-month mark; and
- Of total 2003 originations, 5.6 percent are seriously delinquent at the 11-month mark.

Clearly, these raise serious concerns and we are in the midst of a market transition in response to various of the issues that arose due to the run up in subprime lending the

last several years. In exploring these issues, care is needed to understand and focus attention on the dynamics of the marketplace both to identify the real problems and develop the proper solutions.

In particular, there are issues related to subprime versus predatory lending (explored below) and concerns with poor underwriting practices (in the prime, Alt-A and subprime markets). Some of these activities, of course, arose from predatory lending practices, but many were simply inappropriate practices in response to a hot housing market. With respect to this latter point, I note that many of the issues we are discussing today were driven by market participants either outside of or marginally involved with the insured institution sector. The ability of the FBAs to reach these market players is limited largely to influencing the behavior, activities and operations of the institutions we regulate.

III. Subprime versus Predatory Lending

At the outset, I believe it is worth noting what may seem obvious but often gets misconstrued in the context of discussions on subprime lending and predatory lending. That is, these are not the same thing. While there is significant debate about the appropriateness of lending in the subprime market, particularly with respect to rates and terms offered to many subprime borrowers, a subprime loan is not per se predatory. For that matter, predatory lending practices may be found in the prime market as well as the subprime market.

For example, a retired homeowner with significant equity in his or her home but an income stream primarily limited to social security may have a reasonably high FICO score. If a broker lures the retired homeowner into an unacceptable mortgage under the guise that he or she can get cash out of her property but without full disclosure of the terms of the loan, this predatory action does not involve a subprime borrower.

By contrast, someone employed who has an accident and incurs significant medical bills may have a temporary delinquency problem. He or she may become 30 – 60 days delinquent on some bills but eventually will manage to bring everything current. If the person is fully employed and wants to purchase a home for his family, the delinquency may have hurt his FICO score, putting him into a "subprime" category. Nonetheless, he or she may be a good credit risk for proper loan underwriting. This type of subprime loan is not predatory.

Generally, a loan is predatory where a lender has information that it deceptively withholds from, or misstates to, a borrower knowing or reasonably concluding that the availability of the information to the borrower could affect its decision to obtain credit on the terms offered by the lender. By contrast, a subprime loan is one made to a borrower

who has one or more risk factors that suggest the loan has a higher risk of default than a similar loan to a borrower with a good credit and debt payment history.

One other point critical to the present discussion is the concept of the fully indexed rate. Generally, the fully indexed rate is the interest rate at which a borrower would be qualified for a fully amortizing loan that is held to maturity. The discount rate is the introductory, start or teaser rate that is charged for a loan that may or may not be fully amortizing. In the case of a prime mortgage, the rate (referred to as the "teaser" rate) may be substantially lower than the fully indexed rate for a particular borrower. By contrast, the start rate (typically referred to as the "discount" rate) on a subprime mortgage loan is generally no more than 200 to 300 basis points, and occasionally lower.

IV. The Proposed Subprime Guidance

A. Overview on Development of the Proposal

The proposed guidance on subprime hybrid ARMs highlights the federal banking agencies' (FBAs) concerns with respect to the use of these products in the recent housing market. However, as described more fully later in this statement, the laws and rules that address the origination, marketing and safe and sound underwriting of these products have been in place for many years at the OTS. In fact, the FBAs issued guidance specifically addressing concerns with subprime lending programs in March 1999 and again in February 2001.

In the March 1999 guidance, the FBAs outlined the risks inherent in subprime lending, including the types of controls necessary to engage in this lending activity. The guidance notes that subprime lending is a high risk activity that can lead to higher default rates than many lenders may expect.

The May 2001 guidance amplifies this point by noting that institutions engaged in subprime lending are responsible for quantifying the additional risks in their subprime lending activities. The guidance further notes that institutions engaged in subprime lending programs are expected to determine the appropriate amount of their level of Allowance for Loan and Lease Losses (ALLL) and capital required to offset subprime lending risks.

In the current proposal, the FBAs are particularly concerned about loans marketed as "credit repair" products that often involve liberal underwriting and a loan structure that requires frequent refinancing. Product features that are of concern include:

- Loans marketed principally to subprime borrowers;
- Loans with significant prepayment penalties;
- Loans underwritten with high debt-to-income ratios;

- Loans that pose significant payment shock; and
- Loans that result in frequent refinancing in order to maintain an affordable monthly payment, but that strip equity in the process.

Aside from these general observations, our views on the proposed subprime guidance that is currently out for comment are limited to a description of the proposal and the basis for its issuance. Our discussion is not intended to suggest our final views on the appropriate handling of these products, nor that our position has been decided or predetermined. We encourage all interested parties to provide their views to guide us in formulating final guidance.

Finally, it is important to bear in mind the nature of agency "guidance" and its enforceability. Guidance, particularly on an interagency basis, is typically intended to present supervisory and/or regulatory views on the implementation and applicability of existing laws and regulations to a particular issue or emerging set of circumstances that warrant heightened attention or supervisory scrutiny. Guidance provides a flexible approach to highlight issues or concerns versus a more proscriptive regulatory approach that has the potential of producing unintended consequences in an area that may be highly volatile and reactive.

One of the benefits of guidance (versus a regulation) in the current context is that it provides the FBAs the ability to address ongoing issues that may arise from future market innovations not anticipated at the time the guidance is finalized. This is particularly important in the context of the subprime market where the availability of credit can be significantly influenced by government policies affecting credit providers. While we want to intercede to weed out irresponsible and predatory lenders, we do not want to shut off the availability of credit to the subprime market. Again, subprime lending is not per se predatory lending. As you are aware, the subprime market raises numerous unique challenges, not the least of which are ensuring that subprime borrowers continue to have access to credit from regulated depository institutions and not be forced to turn to other less regulated or unregulated credit providers.

B. Description of the Proposal and Request for Comments

As stated previously, the proposed interagency subprime guidance focuses on loans involving repayment terms that exceed a borrower's ability to service the debt without refinancing or selling the property. The proposal specifies that an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The proposal also underscores that communications with consumers should provide clear and balanced information about the relative benefits and risks of the products.

Generally, there are three issues that are motivating a high degree of concern with the subprime, and Alt-A mortgage markets. Each of these issues figures prominently in the FBAs' interest in the proposed subprime guidance. These are:

- The role that "payment shock" plays in subprime defaults;
- The significant rise in "early payment defaults" among subprime borrowers in the last year; and
- The lack of adequate underwriting standards that appears to have precipitated escalating delinquency and foreclosure rates in the subprime market.

Of these issues, clearly the most pivotal is the maintenance of sound underwriting. It is particularly concerning to hear of so-called "low-doc" or "stated income" loans being extended to borrowers with marginal credit histories. As numerous observers have noted, this is also a recipe for increased mortgage fraud – another concern in the subprime market.

In connection with the proposed guidance, we are particularly interested in obtaining comments on a number of issues. These include:

- Whether subprime hybrid loan products always present inappropriate risks to institutions and consumers, or the extent to which they can be appropriate under some circumstances;
- Whether the proposed guidance statement would unduly restrict existing subprime borrowers' ability to refinance their loans;
- Whether other forms of credit are available that do not present a risk of payment shock;
- Whether the principles of the proposed guidance should be applied beyond the subprime ARM market; and
- Whether limiting of prepayment penalties to the initial fixed-rate period would assist consumers by providing them time to assess and act on their mortgage needs.

Again, while we do not wish to comment beyond the issues already discussed given that the guidance is out for proposal, these are issues of great concern in the current housing market. Comments are extremely important in further guiding the FBAs in this process. We are requesting comments on the proposed subprime guidance by May 7, 2007.

At this point, it also bears noting that the proposed subprime guidance applies to insured depository institutions, including banks, thrifts and credit unions. It does not apply to state-licensed mortgage brokers or other state-regulated and/or unregulated mortgage bankers and lenders. While we applaud the efforts of CSBS and AARMR to enlist the support of 29 States and the District of Columbia to adopt nontraditional mortgage guidance similar to that issued by the FBAs last fall, we believe that it is

perhaps more imperative that the States take similar action with respect to guidance or laws targeted at subprime lenders within their jurisdiction.

According to some estimates, somewhere between 70 to 80 percent of subprime loans are originated through mortgage brokers. Unfortunately, there are wide variations is estimating the number of licensed mortgage brokers in the U.S. Of the estimates that are available, the numbers do not include numerous individuals who work as loan originators for and/or under the direction of a licensed mortgage broker; nor do the numbers identify mortgage brokers operating without any type of license or registration.

In addition, while mortgage brokers are typically required to obtain a state license, in many cases there are no testing or education requirements that are part of that process. Complicating the picture is that background checks may be run only against a state's own criminal database, but not against the FBI's national criminal database.

It was also recently reported in the American Banker that there are eight states that have no regulation of mortgage bankers and lenders. Thus, while these states license mortgage brokers with respect to the activities involved in originating a loan, the entity that may be funding the loan, i.e., a mortgage banker or lender, is not regulated. Two of the states that do not regulate mortgage bankers also happen to have the highest delinquency rates for subprime hybrid ARMs, with delinquency figures substantially above the national average.

We understand that CSBS and AARMR are currently working on a nationwide residential mortgage licensing program to address part of the problem. We have been advised that the initiative will create uniform national mortgage broker and lender licensing applications and a centralized database to house relevant information regarding mortgage brokers and lenders. We applaud this initiative and encourage all States to participate in the CSBS/AARMR program. Of particular note, this initiative will free up scarce State resources currently used for processing licensing applications and permit the States to focus greater attention on supervision and enforcement of mortgage brokers and lenders.

Again, however, this is only part of what is required to address the existing problem with the activities of state regulated mortgage brokers and lenders. We encourage CSBS and AARMR to work with their member States to review and comment on the proposed subprime guidance, and to consider appropriate action at the state level to pursue similar standards.

V. Subprime Hybrid ARMs and Foreclosure Rates

A growing number of mortgage industry analysts are predicting significant increases in mortgage foreclosure rates. Traditional causes of foreclosure include

significant medical expenses, job loss, divorce, and other unexpected challenges. Additionally, unscrupulous or predatory lending practices can also result in mortgage foreclosures.

And while there are more dual-income families servicing today's mortgages, today's mortgages (proportionate to incomes) are growing ever larger due to the high cost of housing in many markets. The financial impact of these larger mortgages grow exponentially with any upward movement in interest rates and/or loan balances, as allowed under the terms of many of today's mortgage products.

The proposed subprime guidance was issued in response to concerns that certain subprime hybrid loan products, which increased in volume significantly the past few years, are posing greater risks to lending institutions and borrowers. Although the interests of these two groups – lenders and borrowers – are covered by the proposed subprime guidance, in fact it is borrowers who remain most exposed to the potential fallout in the subprime market. While the banking industry may have some exposure to subprime lending, it appears to be generally insulated from any significant impact. This is due in large part to the nature of the regulatory regime under which these institutions operate. The difficulty is how to protect the consumer/borrowers, particularly where their exposure comes from activities predominantly outside the regulated banking industry.

It is irrelevant to a consumer who is the recipient of a bad subprime loan whether an insured bank, a mortgage bank or a mortgage broker made the loan to them. If the consumer cannot make the payment, the result is the same. Payment shock is no different whether the loan is held in portfolio by an insured institution or sold through a securitization process to foreign or domestic investors. The problem is how to curtail irresponsible subprime lending based on poor underwriting while not shutting down credit to the subprime market.

For the most part, these are not issues for regulated depository institutions, although some will feel the fallout from their subprime programs. Rather, the problem exists largely outside the scope of insured institutions.

A. National and Industry Foreclosure Rates

Based on the data currently available to us regarding subprime lending activities and the exposure of institutions that we regulate to this market segment, we can make a number of observations. First, external data available to us shows that the foreclosure rate on subprime mortgages nationwide, i.e., for all lenders, as of December 2006 was 3.63 percent of outstanding subprime mortgage products. This compares to a foreclosure rate of 2.48 percent one year earlier. This represents a year-over-year increase of 46 percent. While this large percentage increase is clearly a concern, it is important to keep it in context. For example, at 3.63 percent, the current foreclosure rate is where it was in

September 2003, and substantially lower than the rate of 4.73 percent in December 2001. In other words, while the recent percentage increase is significant, in aggregate, the current level is not extraordinary.

The same cannot be said, however, in the Alt-A mortgage market. While the Alt-A foreclosure rate remains lower than the subprime rate – 3.26 percent compared to 3.63 percent as of December 2006, the increase in Alt-A foreclosures is daunting. Since December 2005 the Alt-A foreclosure rate has increased 65 percent, from 1.97 percent to 3.26 percent. In comparison, as noted earlier, the subprime foreclosure rate is up 46 percent for the one-year period.

There is substantial evidence suggesting that low-doc underwriting is the significant driver of problems in the Alt-A market. According to one estimate, these low-doc or stated income loans represented 81 percent of total Alt-A originations in 2006.

Within the thrift industry, we survey our institutions semi-annually on their subprime lending activities. As of December 2006, we had 19 (out of 845) thrifts with significant subprime lending operations. These institutions reported having approximately $35.4 billion (a 25 percent decline from mid-year holdings of $47 billion) in subprime mortgage products. This amount represents about 7.5 percent of the home mortgages held by these particular lenders, and 5 percent total OTS-regulated thrift industry home mortgage holdings.

OTS-regulated thrift institutions engaged in subprime lending programs are well capitalized, and are all subject to heightened supervision and regulatory scrutiny by OTS examiners with respect to the conduct and operation of these programs. As described below, examiner oversight is tied into our agency-wide consumer complaint program. Institutions with significant consumer complaint activity regarding their mortgage lending operations are subject to heightened scrutiny. While we do not separately track the performance of subprime loan products held by thrift institutions, aggregate foreclosure rates for the industry are currently running about 0.065 percent per quarter, or about 0.26 percent on an annualized basis. While the current rate is up slightly, it is about where it was in 2004.

Comparing this data with the nationwide data available to us on subprime loan performance provides some additional analysis that is helpful to understand the portion of the subprime market currently occupied by the thrift industry. We know that subprime mortgage performance is heavily affected by local economic conditions. According to nationwide data available to us, the states with the highest foreclosure rates are Ohio, Indiana, and Iowa. California, the state where thrift industry subprime lending activity is concentrated, ranks well below the national average, with a foreclosure rate of 2.73 percent. From this, we conclude a lower aggregate industry exposure and foreclosure rate than the national averages.

With respect to thrift industry exposure to potentially increasing foreclosure rates predicted by some experts, the industry is well positioned from a capital and earnings standpoint to absorb such an increase in losses, should it occur. We encourage our regulated institutions (and, as described more fully below, particularly those with subprime lending programs) to work closely with borrowers to address potential foreclosure issues as quickly as possible in order to protect both the institution and the borrower. And we are closely monitoring those thrift institutions having significant subprime lending operations.

Another important consideration regarding thrift industry involvement in subprime lending programs going forward is the recent increase in early default put-backs among subprime securitizations. This has caused some smaller mortgage banking firms (but no thrift institutions) that specialized in subprime lending to fail. The reaction of the secondary market to this perceived increase in risk has been to lower the price on such securitizations. Lower prices, in turn, have reduced the attractiveness of engaging in such securitizations. The likely impact is to reduce the profitability of subprime lending and, thus, the attractiveness of the activity.

At this point, OTS-regulated institutions' exposure to these "early payment default" (EPD) put-backs appears to be minimal, although we expect repurchase demands to continue to rise over the course of this year. And there are several isolated instances of thrifts with heightened levels of put-backs. Of the six institutions that have reported put-backs as of December 31, 2006, the reported amount equaled approximately 2.65 percent of the respective institutions' Risk-Based Capital as of the reporting date.

We are continuing to monitor thrift institutions' exposure to this area, and are well aware of the significance of early detection of potential problems. Many of our institutions with more significant levels of exposure to the subprime market have already begun to pare down their participation in this market. In fact, initial data from a year-end survey of thrifts suggest that subprime lending by institutions involved in this market has slowed at least as much as the overall mortgage market, if not more. We expect the impact on securitizations to further reduce this activity.

B. OTS Oversight of Thrifts with Subprime Lending Programs

As part of our normal oversight process for all institutions, the OTS maintains contact on a quarterly (or more frequent) basis with institution management. This dialogue includes a discussion of new products, including subprime lending activities. We also prepare a quarterly subprime report for institutions with significant subprime lending programs (i.e., subprime lending activities that exceed 25% of their capital), and conduct a quarterly survey of the nontraditional mortgage activities of the institutions we regulate. Finally, the OTS has a Core Specialty Program with specialized examiners

dedicated to reviewing institutions' operations in mortgage banking, credit card and auto lending, nontraditional mortgages, and securitizations.

As noted previously, thrift institutions engaged in significant subprime lending activities are subject to heightened OTS supervision and oversight with respect to the conduct and operation of these programs. During the normal course of examinations, institutions with subprime credit programs are reviewed from a safety and soundness and consumer protection perspective, and are also scrutinized to ensure that the institution is lending responsibly and following all applicable laws and regulations.

In light of recent developments in the home mortgage market, the OTS has revised and will issue shortly its examiner guidance on home mortgage lending and servicing. The examiner guidance re-emphasizes our existing policy on foreclosures and, in doing so, explicitly recognizes that foreclosure is seldom a cost effective option, and encourages lenders to make special efforts to develop and maintain effective servicing and collection procedures for home mortgages that become delinquent. For example, the guidance suggests that lenders involved in subprime lending should have their collection efforts focus on quickly contacting a delinquent borrower, understanding the reason for the delinquency, and providing borrower counseling when necessary.

In addition, the OTS's long-standing guidance on servicing states that a thrift's collection activities must comply with the following:

- The Fair Debt Collection Practices Act – in particular, the law defines from whom a debt collector may gather information on a consumer, the type of information that it may collect, and the acceptable forms of communication with the consumer and other parties;
- State laws that pertain to collection and foreclosure actions; and
- Bankruptcy law – an institution's collection activity is affected by any bankruptcy plan into which a debtor has entered. For instance, the filing of a bankruptcy petition acts as an automatic stay on any collection activities in process at the time. After such filings, collection efforts usually process through the bankruptcy court.

In some cases, a collection unit may enter into a short-term forbearance arrangement with a delinquent borrower before beginning a foreclosure action. For example, a servicer may permit the borrower to defer payments, follow an alternative repayment plan, or execute a deed in lieu of foreclosure (which grants the borrower full forgiveness of the debt). And the use of some loss mitigation techniques, such as waiving a due-on-sale clause to allow an assumption, may require an institution to repurchase the loan out of its mortgage-backed security pool. We expect thrift management to have information systems adequate to analyze these forbearance activities.

While we stress the need for an institution to work with its borrowers to resolve any payment delinquencies, we also stress the need for the institution to be fully aware of, report properly, and reserve adequately for its troubled loans. Transparency of operations is critical to a safe and sound banking system.

As noted elsewhere in this statement, loan forbearance and foreclosure strategies that are developed and implemented as a win-win for the lender and borrower are generally significantly more cost-effective from a safety and soundness standpoint. We encourage all of our regulated institutions to consider and adopt such programs in a manner consistent with their safety and soundness and the protection of their customers.

C. OTS Enforcement Activities

When an institution's lending programs are found to be potentially predatory or are lacking adequate controls to support responsible lending, there are numerous options that the OTS can take to eliminate these risks. These include informal agreements, supervisory directives, board resolutions, and various other approaches.

For example, in one relatively recent case we addressed a series of transactions where an institution entered into an agreement with an affiliated entity to originate and fund subprime loans through the institution. The affiliate provided loan sourcing and origination services, and assisted in the disposition of the originated loans to investors.

In reviewing the parameters of the relationship between the institution and its affiliate, OTS examiners determined that the thrift was not managing the relationship appropriately, and insufficient controls were in place to fully ensure effective lending practices. And there was also an indication that some of the lending practices were abusive. In response, the agency issued supervisory directives and required board resolutions to address the problem. The thrift's relationship with the affiliated entity was terminated one month after the OTS took action to address the matter.

In another case involving an institution with a high level of customer complaints regarding potentially abusive lending practices, OTS examiners were sent to the institution to review the institution's lending practices and program. Pursuant to that review, the institution was directed to implement adequate policies to address and resolve various unacceptable lending practices. When the institution failed to address these issues in a timely manner, the OTS initiated an enforcement action against the thrift.

Pursuant to the OTS's enforcement order, the institution signed a written supervisory agreement with the OTS in which it agreed to improve its compliance with the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act and the Fair Credit Reporting Act. In addition, the institution agreed to create a "Consumer Ombudsman" responsible for "fairly and impartially reviewing and addressing

[customers'] borrowing issues in a timely and effective manner." The agreement also required the development of borrower-oriented customer service plan/practices, and a consumer dispute resolution initiative plan among other things.

Approximately one year following the execution of the supervisory agreement, the OTS approved the institution's request for "voluntary dissolution".

In two other cases, similar results were achieved. Using a combination of formal and informal enforcement actions, the agency forced the discontinuation of lending operations by two federally chartered thrifts based on poorly supervised lending activities. In both cases, subprime lending programs that exhibited predatory features coupled with lax management oversight controls were effectively terminated. A significant concern by the OTS staff was an effort by both institutions to attempt to exploit the charter to engage in lending programs lacking adequate consumer protections and management controls.

In another case, OTS staff shut down a program by a federal thrift that utilized brokers to do out-of-state lending activities, again, that were lacking sound consumer protections and controls. The agency's directive to the institution concluded that the activity was tantamount to a charter rental strategy intended to avoid State and OTS oversight of out-of-state lending activities by the institution.

We also impose conditions requiring responsible lending policies and barring abusive practices by an institution, its holding company and affiliates at the time of an acquisition. Typically, these types of conditions are appropriate where we know or have reason to believe that an acquirer plans to start or continue an existing subprime lending program at a newly acquired or *de novo* institution. Whenever such conditions are imposed, regional staff will work closely with and monitor the institution and its holding company/affiliates to ensure that adequate controls are imposed and maintained in connection with the subprime lending program.

Finally, we recently addressed an issue with an institution engaged in what we viewed as a potentially abusive subprime credit card lending program. The nature of the program was uncovered in the normal course of an examination. In connection with the resolution of that matter, we directed the institution's board of directors to establish a systematic process to withdraw from the subprime credit card program, and immediately cease new approvals under the program.

Although this was a more informal action pursued in the course of an examination, the result was that the program's growth was immediately terminated, and the program itself was unwound within a reasonably short timeframe following the examination.

There are numerous other such examples of actions taken by the OTS in the course of examinations of the institutions we regulate. While we find informal actions to be an effective mechanism to address these types of supervisory concerns, we do not hesitate to use our formal enforcement authority when appropriate to do so. Fundamental to our continuing oversight of the industry we regulate is ensuring that institutions conduct their activities in a manner consistent with sound consumer protection.

VI. Predatory Lending and OTS Efforts to Combat the Problem

A. OTS Examination Efforts

The OTS regularly examines thrifts for compliance with federal compliance and consumer protection statutes including fair lending statutes such as the Equal Credit Opportunity Act, the Fair Housing Act, and the Truth in Lending Act. In addition, the OTS examines for compliance with our regulations that prohibit discrimination and misrepresentations in advertising. We also examine to ensure compliance with interagency guidance on subprime lending, such as the 1999 Interagency Guidance on Subprime Lending and the 2001 Expanded Guidance for Subprime Lending Programs.

Finally, we are currently developing enhanced examination procedures that specifically address responsible lending practices for our regulated lenders that have a subprime lending program. These procedures direct examiners to focus on various issues and institution program areas, including:

- Whether institution marketing materials are well designed to present the typical consumer with adequate information to help them make informed product choices;
- Whether institution sales practices – either through loan officers or third parties – may tend to mislead a consumer about the nature and scope of a credit transaction or may impose pressure on consumers to accept terms and conditions based on incomplete or unbalanced information;
- Whether institution employee training programs, including training provided to third party vendors that interact with institution customers, foster best practices; and
- Whether existing institution practices may have the effect of steering particular groups of consumers to less favorable credit products or higher cost credit products than their credit risk profile warrants.

We are in the process of field testing these examination procedures with formal adoption expected as soon as practicable after making any necessary adjustments upon conclusion of the field testing exercise.

B. Utilization of Consumer Complaint Data

The OTS continually tracks individual institution consumer complaints relating to various potential regulatory violations, such as the Equal Credit Opportunity Act, and with respect to product offerings, such as ARM products. Consumer complaint staff and managers prepare summaries of consumer complaints for OTS examiners to utilize in their review during on-site examinations.

Institution consumer complaint records are an integral part of an the OTS's individualized Pre-Examination Response Packages (PERK) for each institution, and play a significant role in identifying areas for examiners to focus on during their on-site examination. These records also play a critical role in assessing the adequacy of an institution's overall compliance management program and in pursuing corrective action that may be appropriate to address programmatic weaknesses or deficiencies.

C. OTS Examiner Consumer Compliance Test

OTS recently developed an examination that is used to test and train OTS examiners regarding their level of proficiency across a broad range of consumer compliance laws and regulations. We developed this in-house examination in order to continue to ensure that OTS examiners have significant knowledge regarding consumer compliance requirements and agency expectations of the institutions that we regulate. The new test will assist us in working with our examiners to develop professionally in order to effectively examine thrift institutions, many of which have complex, retail-focused business models.

D. Consumer Education and Responsibility

The OTS has worked on its own and cooperatively with various other agencies and organizations to promote consumer education and responsibility. We also have various initiatives to improve financial literacy and we work closely with our institutions to encourage them to do the same.

1. The CHARM Booklet

One interagency initiative involved working closely with the Federal Reserve Board to assist consumers in navigating their choices among mortgage products. The product of that effort, a consumer disclosure brochure entitled the Consumer Handbook on Adjustable Rate Mortgages – or CHARM booklet, was revised and re-released on December 26, 2006. The CHARM booklet provides information to consumers about the features and risks of ARM loans, including the potential for payment shock and negative

amortization. It is tailored to help consumers better understand some of the issues and potential pitfalls with newer loan products

In particular, the CHARM booklet was substantially revised to address the growing use of NTM and newer types of ARM products that allow borrowers to defer payment of principal and sometimes interest. For example, it includes information for consumers on both "interest-only" and "payment option" ARMs. The revised booklet describes how these loans typically work, demonstrates how much (and how often) monthly payments could increase, and describes how a loan balance can increase if only minimum monthly payments are made. The booklet, which is a required consumer disclosure for ARM loans, also includes a mortgage shopping worksheet to help consumers compare the features of different mortgage products.

2. The Interest Only-Pay Option Mortgage (IO-POM) Brochure

The OTS also contributed to the development of an interagency consumer informational brochure addressing interest-only and payment option mortgages. This brochure describes payment shock and negative amortization. This work is ongoing, with illustrations of these types of mortgages being developed to educate consumers on the points discussed in the brochure.

3. The OTS Consumer Complaint Brochure

In connection with our agency-wide program for National Consumer Protection Week in February, the OTS issued a consumer information brochure on how consumers can resolve complaints with financial institutions. That brochure highlights various steps that consumers can take in order to attempt to resolve a complaint. First, consumers are encouraged to try to resolve a problem directly with an institution by contacting senior management or the institution's consumer affairs department. If this is unsuccessful, consumers are advised to contact the appropriate OTS regional office for institutions regulated by the OTS or, if the entity is not OTS-regulated, the guidance provides information for identifying the appropriate federal and/or state regulator for various types of financial institutions. Finally, the brochure reminds consumers that the best way to pursue a complaint or concern is to make sure that it is well documented.

4. OTS's National Consumer Protection Week Program

The OTS Consumer Complaint brochure was part of a 5-day series of consumer protection and awareness initiatives during National Consumer Protection Week. During the week, the OTS also highlighted various issues for thrift institutions and resources available to consumers on financial literacy and education via press releases. We also noted that the agency's five day National Consumer Protection Week program was part of a wider agency initiative intended to bolster OTS efforts to assist institutions in working

with their customers to improve financial literacy and education. And it is part of an ongoing effort to upgrade substantially the agency's own compliance, consumer protection and consumer awareness programs.

An important aspect of the OTS's efforts to upgrade our own consumer awareness and protection programs is monitoring emerging trends and evolving financial products in order to develop appropriate guidance for institutions and resources that assist consumers in making informed financial decisions. As we stressed before the Financial Literacy and Education Commission (FLEC) earlier this year, financial literacy and education is equally important to institutions and the customers they serve.

During National Consumer Protection Week, we also issued a press release reminding consumers about the risks presented by identity theft and steps to guard against it. The release highlighted for consumers their right to take advantage of a free credit report from the major credit reporting agencies pursuant to the Fair Credit Reporting Act.

We noted that careful credit report monitoring not only helps consumers obtain credit at rates commensurate with their credit history, it also helps to guard against identity theft. We also encouraged all of the institutions we regulate to work with their customers to increase awareness of the importance of periodically monitoring their credit report. We reminded consumers that credit scores largely determine the cost they pay to receive loans and that over time, a consumer's ability to pay lower interest rates to a lender because of a positive credit score can save them lots of money. We also noted that insurance companies and employers also utilize information from credit reports, stressing how important it is for all of us to know what's in our credit reports.

5. The NeighborWorks Center for Foreclosure Solutions

As a member of the NeighborWorks America board of directors, I have been working with several of my colleagues on a national campaign on foreclosure prevention. The NeighborWorks Center for Foreclosure Solutions is a resource that is available to provide assistance (in both English and Spanish) to provide credit counseling, rescue funds, refinance loans and other services to homeowners facing foreclosure.

E. The OTS National Housing Forum

1. Mortgage Fraud

At the National Housing Forum (NHF) sponsored by the OTS in December 2006, another issue affecting the subprime mortgage market was highlighted. The NHF included a panel on mortgage fraud that featured an important discussion on the impact of mortgage fraud on financial institutions and borrowers. The panel discussion highlighted the fact that regulated institutions reported over a $1 billion in losses from mortgage fraud

in 2005. And reports of suspected mortgage fraud doubled in just three years from 2003 to 2006.

The panel discussion noted that mortgage fraud can be divided into two broad categories – fraud for property and fraud for profit. Fraud for property generally involves misrepresentations or omissions designed to deceive the lender into extending a mortgage. Fraud for profit, frequently committed with the complicity of industry insiders, involves fraudulent appraisals, property flipping, straw borrowers, and identity theft. Fraud for profit frequently involves large schemes, concocted by sophisticated criminals. This is an important point in the context of the current discussion and, unfortunately, one that is not easily quantifiable with respect to the impact on subprime borrowers.

While lenders and consumers have benefited significantly from lower interest rates and a mortgage boom the past several years, higher loan volumes have encouraged lenders to develop ways to cut costs and create efficiencies in the mortgage underwriting process. And the recent moderation in housing has added pressure to exploit these efficiencies in order to capture demand while retaining profits. It is certainly true that mortgage lending innovations have produced efficiencies that are good for lenders and borrowers. Yet, while such innovations have made borrowing easier and more user-friendly, they have also provided opportunities for fraud to proliferate. This is an ongoing issue of concern to the OTS and all participants in the mortgage markets.

2. Housing Outlook

In addition to a mortgage fraud panel, the OTS NHF featured key industry players discussing issues on the economy and the short- and long-term prospects for housing in the U.S. The discussion included extensive data and input on various mortgage products, the impact from the use of nontraditional mortgages in the current market, and concerns regarding the impact on institutions, homeowners and the broader economy of rising delinquency and foreclosure rates. Subprime lending concern were voiced by numerous participants.

F. OTS Community Outreach Activities/Partnership Building

Another important aspect of OTS efforts to combat predatory lending is a community outreach program that includes designated community affairs liaisons – known as CALs – in each of our regional offices. OTS CALs conduct various regional outreach efforts to help identify community credit and banking needs, and match those needs and opportunities with our regulated thrifts. Over 30 new community contacts were established in 2006 to complement our many existing community-based partners. Such partners include financial institutions, government agencies, community based organizations, non-profit groups, and social service agencies. Our CALs address and work on affordable housing and economic development needs, best practices for serving

emerging markets, elder financial abuse issues, financial literacy programs, and other initiatives targeted at low- to moderate-income individuals and communities.

Regional programs, organizations and forums in which OTS CALs and other OTS employees are involved include a Boston New Alliance Task Force in October 2006 addressing the unbanked and underbanked; two events in 2006 involving the New York New Alliance Task Force that involved outreach to community-based entities that cater to the needs of the unbanked and underbanked; a joint summit on financial fraud prevention in December 2006 sponsored by our Northeast Regional Office and the New England Consumer Advisory Council.

Other organizations that we worked with during 2006 include the Housing Leadership Council of San Mateo County, California; Lenders for Community Development, in San Jose, California; Coachella Valley Housing Coalition, Indio, California; the Fair Housing Councils of Riverside County, and Palm Springs, California; the San Francisco Housing Development Corporation; the San Francisco Planning and Urban Research (SPUR) Association; Los Angeles Neighborhood Housing Services; and the Clearinghouse for Affordable Housing CDFI.

We also worked closely to develop further relationships with nationally recognized community organizations such as the Greenlining Institute, the California Reinvestment Committee, and Operation HOPE. And we collaborated with our sister FBAs to co-sponsor three community development training events during 2006 – a National Community Reinvestment Conference, in Henderson, Nevada; the Greater Sacramento CRA Roundtable, in Sacramento, California; and "Exploring the Valley's Unbanked Opportunity," in Fresno, California.

Finally, we assist in providing basic financial education training, such as to a class of graduating high school seniors in San Francisco, and providing financial education training at a low- to moderate-income community center in Palm Springs, California. And we plan various other financial education and literacy outreach events for 2007.

VII. Conclusion

The OTS shares the concerns of the Subcommittee with respect to current issues related to subprime hybrid ARMs. The use of subprime hybrid ARMs and predatory lending practices – in both the prime and subprime markets – have impacted the nationwide housing market. However, at this stage of the cycle the aggregate impact of subprime lending and predatory lending remain unclear. While some suggest that there is much more to come, others note that banks and thrifts are well-positioned from both a capital and earnings standpoint to weather even a sustained market downturn. For now, the data currently available to us indicate that regulated institutions have been migrating out of the subprime market sector. While we expect some institutions to continue to

operate in this market, it appears that most insured depository institutions are fully cognizant of the risks posed with subprime hybrid ARMs and are underwriting these loans accordingly.

For our part, we will continue to work with our institutions to ensure safe and sound underwriting standards that benefit both the institutions that we regulate and their customers. In addition, we will encourage institutions to work with borrowers that are experiencing problems due to personal circumstances outside of their control. While we do not see a need for legislation at this time, we encourage the Members of this Subcommittee and the public to comment on the interagency proposed subprime guidance to guide the FBAs in this process. Finally, we will work with the Subcommittee to address issues with subprime lending, as well as to combat predatory lending.

Thank you for the opportunity to present our views on these issues.

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STATEMENT

OF

THE HONORABLE JOANN M. JOHNSON
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

"SUBPRIME AND PREDATORY LENDING: NEW REGULATORY GUIDANCE, CURRENT MARKET CONDITIONS, AND EFFECTS ON REGULATED FINANCIAL INSTITUTIONS"

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
U.S. HOUSE OF REPRESENTATIVES

TUESDAY, MARCH 27, 2007

I. Introduction

NCUA's primary mission is to ensure the safety and soundness of federally insured credit unions. It performs this important public function by examining all federal credit unions, participating in the supervision of federally insured state chartered credit unions in coordination with state regulators, and insuring credit union members' accounts. In its statutory role as the administrator for the National Credit Union Share Insurance Fund, NCUA provides oversight and supervision to approximately 8,362 federally insured credit unions, representing 98% of all credit unions and approximately 87 million members. [1]

Federally insured credit unions' holdings of mortgage loans represent a relatively small part of the overall mortgage market. Mortgage lending in federally insured credit unions is mostly comprised of traditional fixed rate mortgages where the risk of payment shock or negative amortization is minimal. However, some federally insured credit unions offer nontraditional mortgage products and loans to subprime borrowers as a means of reaching out to disadvantaged and lower income individuals.[2] NCUA supports these outreach efforts when they are part of a planned, controlled, risk based lending program. In guidance issued to all federally insured credit unions, NCUA supports risk based lending programs as a tool to reach out to all credit union members, where the programs are measured and meet supervisory expectations. NCUA has outlined safe and sound lending practices for federally insured credit unions offering loans to borrowers who access subprime products in order to obtain credit through risk based lending programs.

NCUA carefully monitors mortgage performance indicators in federally insured credit unions to gauge the effectiveness of underwriting and collection activity. To date, federally insured credit unions have not experienced an unsound level of mortgage loan delinquency, net charge-offs, or foreclosures. Through examination, NCUA ensures federally insured credit unions have adequate collection policies and procedures in place. To the extent federally insured credit unions face increasing mortgage defaults, NCUA expects they will follow normal collection policies and procedures in working with members to return them to a current payment status where possible.

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[1] Approximately 174 state chartered credit unions are privately insured and are not subject to NCUA oversight.

[2] NCUA defines subprime borrowers as those who have weak credit histories (e.g., delinquent payments, charge-offs, judgments, bankruptcies), or reduced payment capacity (e.g., high debt ratios or low credit scores). The same definition was used by the other federal financial institution regulatory agencies in 2001 guidance entitled *Interagency Guidance on Subprime Lending: Expanded Guidance for Subprime Lending Programs.*

II. Mortgage Lending in Federally Insured Credit Unions

Mortgage loans in federally insured credit unions represent only 9% of mortgage loans outstanding in all federally insured depository institutions.[3] In 2006, the Mortgage Bankers Association estimated mortgage loan originations in the marketplace of over $2.51 trillion, of which federally insured credit unions originated only 2% or $54 billion.[4]

Approximately 68% of federally insured credit unions offer mortgage loans to their members. Those not offering mortgage loans are generally smaller federally insured credit unions that cannot afford the expertise or infrastructure required to manage significant mortgage portfolios. Additionally, smaller federal credit unions have difficulty implementing a wide range of mortgage products since loans to a single member are statutorily limited to 10% of a federal credit union's total unimpaired capital and surplus.[5] Consequently, as illustrated below, the majority of federally insured credit union mortgage lending occurs in larger credit unions.

Federally Insured Credit Unions by Asset Size	Number of Mortgage Loans Originated in 2006	% of Federally Insured Credit Union Mortgage Loan Portfolio as of 12/31/2006
Greater than $1 billion	509,936	43.02%
$500 million-$1 billion	255,009	17.75%
$50 million-$500 million	560,061	33.03%
$10 million-$50 million	100,546	5.71%
Less than $10 million	9,321	0.49%

Fixed Rate Mortgages in Federally Insured Credit Unions

Totaling $149 billion, traditional fixed rate mortgage loans comprise 61% of federally insured credit union mortgage loans outstanding. Fixed rate mortgage loans accounted for 80% of the increase in mortgage loans in 2006. Of first-lien mortgage loans, 57% are traditional fixed rate mortgage loans.[6] Fixed rate mortgages in federally insured credit unions grew at a rate of almost 16% in 2006, with most fixed rate growth in longer term products. This is likely indicative

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[3] NCUA data and *FDIC- Statistics on Depository Institutions Report, 1-4 Family Residential Net Loans and Leases for all depository insured institutions as of 12/31/2006.* 31 Dec. 2006. Federal Deposit Insurance Corporation. < http://www2.fdic.gov/SDI/SOB>.

[4] NCUA Data and *MBA Mortgage Finance Forecast.* 12 Feb. 2007. Mortgage Bankers Association. <http://www.mbaa.org/files/Bulletin/InternalResource/48425_MortgageFinance MarketForecast-February2007.pdf>.

[5] 12 C.F.R. 701.21(c)(5). Unimpaired capital and surplus equals shares plus post-closing, undivided earnings.

[6] First-lien mortgage loans are loans in which credit unions hold first lien position on the collateral securing the mortgage.

of credit union members refinancing adjustable rate mortgage loans into fixed rate loans as interest rates rise.

Adjustable Rate Mortgages in Federally Insured Credit Unions

Adjustable rate mortgage loans comprise about 39% of all federally insured credit union mortgage loans, and accounted for 20% of the increase in mortgage loans in 2006. While this growth rate is significant, it is down from a 42% increase over this same time period in 2005. In all, adjustable rate mortgage loans grew at a rate of 6%, or less than half the growth of fixed rate mortgage loans in 2006. This indicates federally insured credit union members are refinancing into more fixed rate products in a rising interest rate environment. As of December 31, 2006, adjustable rate first mortgage loans totaled $68.8 billion or about 28% of all federally insured credit union mortgage loans outstanding.

Nontraditional Mortgage Lending in Federally Insured Credit Unions

Nontraditional mortgage products, such as "interest-only" or "payment option" adjustable rate mortgage loans, are also offered in some federally insured credit unions and comprise a smaller subset of adjustable rate mortgage loans. Due to the evolving nature of mortgage loan products, NCUA has not previously collected specific information about the various types of adjustable rate mortgage loans beyond information about their maturities. Given the growth in popularity of nontraditional mortgage products (often referred to as "exotic," "hybrid," or "alternative" mortgage products), NCUA's 5300 Call Report has now been amended to specifically collect data on certain nontraditional mortgage loans. Results will become available after the March 2007 reporting cycle. [7]

In February, the House Committee on Financial Services sent a letter to NCUA and other federal regulators expressing concern about underwriting and consumer disclosure for certain Hybrid Adjustable Rate Mortgages (Hybrid ARMs), including "2-28" and "3-27" adjustable rate mortgages. These loans often have certain features that can present added risks to borrowers and financial institutions if not underwritten properly. NCUA shares the Committee's concern about riskier Hybrid ARMs having features that may be detrimental to consumers, and more particularly, to subprime borrowers.[8]

Current data indicates federally insured credit unions are not heavily involved in Hybrid ARM mortgage lending. As of December 31, 2006, all of the Hybrid ARM products in federally insured credit unions comprised less than 17% of federally insured credit union mortgage loans outstanding. The pool of loans, in which "2-

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[7] NCUA's 5300 Call Report is the data collection tool used to collect required financial statement reports from federally insured credit unions on a quarterly basis.

[8] NCUA alerted its examiners and the credit union industry to the increasing risks in mortgage lending in 2005 with a supervisory alert and letter to credit unions. In 2006, NCUA provided nontraditional mortgage information to its specialized lending subject matter examiners in regional conferences during training sessions.

28" and "3-27" ARMs are reported on NCUA's 5300 Call Report, also contains other more traditional short term Hybrid ARMs, such as "3-1" and "5-1" ARMs. "3-1" and "5-1" ARMs may have less frequent interest rate adjustments and better terms since they are more typically marketed to prime borrowers than are "2-28s" or "3-27s." Federally insured credit unions have offered "3-1" and "5-1" ARMs for many years, whereas "2-28" and "3-27" ARMs have only more recently gained popularity in the mortgage market. For these reasons, it is unlikely that riskier Hybrid ARMs such as "2-28s" and "3-27s," comprise a material portion of all Hybrid ARMs held by federally insured credit unions.

There are several reasons why these riskier Hybrid ARMs are not prevalent in federally insured credit unions. As earlier addressed, many federally insured credit unions are smaller institutions that lack the sophistication or resources to underwrite these types of loans. Second, and very importantly, the Federal Credit Union Act prohibits prepayment penalties and establishes a statutory limit for interest rates not to exceed 18%. [9] Because of these statutory provisions, the regulatory environment for federal credit unions is not conducive to some of the features that make the cost of underwriting these loans more tenable to other types of institutions. For example, some institutions effectively lock subprime borrowers into upward payment adjustments and higher interest rates by charging prepayment penalties if the borrower wishes to refinance the loan.

Mortgage Loan Performance In Federally Insured Credit Unions

Demand for mortgage loans in federally insured credit unions remains high. Mortgage loans led all loan types in growth in 2006, increasing $25.61 billion (71% of all new loan growth) to a new high of 49% of total loans. NCUA continues to closely watch performance indicators in the mortgage lending area through data collection and the examination and supervision process.

NCUA's most current call report data indicates mortgage loan delinquencies greater than 30 days increased in 2006, moving upwards from 0.79% to 0.99%. Mortgage loan delinquencies over 60 days were at only 0.34% of total mortgage loans. While mortgage loan delinquencies in federally insured credit unions have increased overall over the last five years, the level of delinquency has remained sound and relatively consistent, as demonstrated in the following table:

Mortgage Loan Delinquency and Net Charge-Offs In Federally Insured Credit Unions					
Year Ending:	**2002**	**2003**	**2004**	**2005**	**2006**
Delinquency >30 days	0.91%	0.83%	0.77%	0.79%	0.99%
Delinquency >60 days	0.30%	0.28%	0.25%	0.27%	0.34%
Net Charge-Offs/Average Mortgage Loans	0.02%	0.02%	0.02%	0.02%	0.03%

[9] 12 U.S.C. §§1757(5)(A)(vi) and 1757(5)(A)(vii)

As also shown in the table above, while mortgage loan charge-offs increased in 2006, the ratio of net mortgage loan charge-offs to average mortgage loans totaled only 0.03%. Federally insured credit union mortgage loans in foreclosure have increased over the last three quarters from $136 million to $165 million, or by approximately 20%. Still, mortgage loans in foreclosure represented only 0.07% of total mortgage loans outstanding at year-end. While these trends merit continued observation, the above mentioned mortgage loan performance ratios are not alarming.

III. NCUA's Ongoing Efforts to Promote Sound Risk Based Lending

Subprime lending and nontraditional mortgage programs provide access to credit for some members that would not be available in traditional lending programs. In that regard, NCUA fully supports sound loan programs designed to reach out to disadvantaged or subprime credit union members for the mutual benefit of all involved.

Alternative loan products, known as "credit builder," "subprime," "people helping people," and "micro" loans all represent market-driven, practical attempts at providing consumer alternatives. Importantly, federally insured credit unions have utilized subprime lending as a vehicle to reach out to disadvantaged members, providing access to credit to a subset of borrowers who might not otherwise qualify. NCUA has previously issued guidance supporting subprime lending when part of a safe and sound risk based lending program.[10]

NCUA Guidance

Through several issuances of guidance, NCUA has outlined risk based lending concepts. Although mortgage lending is not specifically addressed in these issuances, these concepts are still applicable. NCUA periodically issues guidance to federally insured credit unions through Letters to Credit Unions. Examiners routinely discuss the guidance set forth in these letters with credit union management and evaluate their responses through the examination and supervision function.

Recognizing the emergence of risk based lending efforts in the credit union industry, in 1995, NCUA issued Letter to Credit Unions 174 to all federally insured credit unions discussing the potential advantages and disadvantages to federally insured credit unions of risk based lending programs, or programs

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[10] Risk based lending is a means by which a credit union may be able to more effectively meet the credit needs of all its members. It involves setting a tiered pricing structure that assigns loan rates based upon an individual's credit risk. The precepts of risk based lending are more fully discussed in NCUA Letters to Credit Unions 174, *Risk Based Loans* and 99-CU-05, *Risk Based Lending*.

where subprime credit could be offered. Risk based lending involves setting a tiered pricing structure that assigns loan rates based upon an individual's credit risk. A tiered pricing structure enables federally insured credit unions to make more loans to disadvantaged, lower income, or credit-challenged individuals. Through a carefully planned risk-based lending program, federally insured credit unions can make loans to somewhat higher-risk borrowers, as well as better serve their lower-risk members.

Letter to Credit Unions 174 stated that "[c]redit unions should engage in risk-based lending, not as a means of re-pricing existing balance sheets, but as a tool to reach out to the underserved..." and also noted that "[s]afety and soundness should remain of paramount importance...." Attached to Letter to Credit Unions 174 was an informational whitepaper discussing safety and soundness considerations and stressing the importance of consumer compliance issues related to risk based lending. Specifically, the whitepaper discussed the necessity of planning, policies, procedures, portfolio limitations and monitoring, and effective pricing. Additionally, the whitepaper reminded federally insured credit unions of their obligations under the Equal Credit Opportunity Act, Fair Housing Act, and the Fair Credit Reporting Act. Finally, the whitepaper outlined the examination procedures NCUA would use to review these programs.

In 1999, NCUA issued Letter to Credit Unions 99-CU-05 to all federally insured credit unions restating that soundly managed risk based lending programs were a way to reach out to all members. In Letter to Credit Unions 99-CU-05, NCUA noted that those receiving the largest benefit from risk based lending programs would be individuals attempting to repair or establish credit, but reiterated the need for sound planning, underwriting, monitoring, and control. Additionally, Letter to Credit Unions 99-CU-05 noted that a federally insured credit union's capital adequacy would be evaluated considering the volume and type of risk based lending pursued and the adequacy of the credit union's risk management program. Lastly, Letter to Credit Unions 99-CU-05 provided federally insured credit unions with more information about NCUA's expectations for risk based lending program planning, loan policies, and procedures.

In 2004, NCUA issued Letter to Credit Unions 04-CU-13 to all federally insured credit unions discussing NCUA's supervisory expectations for controls over several types of specialized lending, including subprime lending.
Subprime lending involves higher levels of risk and requires greater skill to successfully implement. Properly managed, however, it can be a viable and safe component of a federally insured credit union's balance sheet. A well-managed subprime program enables federally insured credit unions to serve disadvantaged members. Sound underwriting practices, effective control and monitoring systems and sufficient capital levels are key components to a well-managed program. All of these aspects are more fully elaborated in NCUA's guidance on this topic.

Letter to Credit Unions 04-CU-13 outlined NCUA's underwriting expectations for federally insured credit unions engaged in subprime lending, noting the need to

focus on borrowers' ability to repay loans as structured. A questionnaire on Subprime Lending Controls was also introduced to federally insured credit unions as an attachment to Letter to Credit Unions 04-CU-13. This questionnaire is currently used as part of the evaluation of risk based lending and subprime lending programs in federally insured credit unions with loan portfolios containing significant amounts of subprime loans.

In 2005, NCUA specifically addressed emerging risks in mortgage lending and concerns about alternative or exotic mortgage products in the overall mortgage market when a Supervisory Alert was issued to its examiners. The alert focused on the evolution of products in the mortgage market, the unusual volume of originations of variable rate mortgage products in a low interest rate environment, and the market trend toward liberalization of underwriting standards. The alert outlined potential issues with "interest-only," "payment-option," and "hybrid" adjustable rate mortgages with illustrations of payment shock for each of the products discussed.

The above referenced Supervisory Alert was then issued to federally insured credit unions in October 2005 with Letter to Credit Unions 05-CU-15 which also addressed the use of alternative or exotic mortgage products to afford housing in areas of high housing value appreciation. Additionally, Letter to Credit Unions 05-CU-15 notified federally insured credit unions that "NCUA field staff will be monitoring these trends and will evaluate not only interest rate risk related to mortgage lending but also the increased credit risk associated with these newer mortgage products and more liberal underwriting standards."

In 2006, NCUA issued Nontraditional Mortgage Guidance and began work on Proposed Subprime Lending Guidance, both in tandem with other regulators. While nontraditional and subprime mortgage lending are not major components of federally insured credit union mortgage portfolios, NCUA is concerned that predatory and unsound lending in other areas of the marketplace may increase consumers' monthly debt burdens significantly, resulting in a "ripple effect" that would not only impact credit union members but also federally insured credit union asset quality. If credit union members begin to experience difficulty making payments on homes they have financed elsewhere, loan accounts at their federally insured credit unions will also be impacted. NCUA continues to work with other regulators to finalize proposed consumer illustrations that outline ways to clearly disclose the risks of Nontraditional Mortgage products.

The Interagency Nontraditional Mortgage Guidance was drafted to address loan products with the risks of both payment shock and/or negative amortization. Since fully amortizing loans do not pose a risk of negative amortization, they were not initially included in the guidance. More recently, NCUA participated with the other FFIEC agencies in proposing interagency guidance on Subprime Mortgage Lending bridging the gap between these loan types, and other fully amortizing Hybrid ARMs such as "2-28" and "3-27" adjustable rate mortgages. It would ensure the issue of payment shock is addressed through appropriate underwriting in these loans, which are most commonly offered to subprime

borrowers. The proposed guidance also requests comments regarding whether applying a more stringent underwriting standard to other ARMs would stifle the market or reduce the availability of credit. NCUA will continue to work with the other FFIEC agencies to address this issue through Interagency Guidance and internal implementation.

Consumer Protection for Credit Union Mortgage Applicants

Credit unions must comply with the same mortgage specific federal regulations as other federally insured institutions, including: Truth in Lending (Regulation Z), the Real Estate Settlement Procedures Act (RESPA), the Home Owner's Equity Protection Act (HOEPA), the Flood Disaster Preparedness Act (FDPA), the Fair Housing Act (FHA), and the Home Mortgage Disclosure Act (HMDA).[11] NCUA's examiners review compliance with applicable laws and regulations in the normal course of the examination and supervision process.

As the enforcement authority for HMDA in credit unions, NCUA is responsible for the oversight of HMDA data collection.[12] For the 2005 reporting period, approximately 2,300 institutions overseen by NCUA for the purpose of HMDA reporting submitted loan/application register data. The respondents included federally insured credit unions, non-federally insured credit unions, and credit union service organizations. Combined, the NCUA respondents submitted data for 813,783 loan applications.

Based on the HMDA data collected, credit unions appear to be actively meeting the need for mortgage products among credit union applicants for mortgage credit. Reporting credit unions approved an overwhelming majority of the applications processed during the 2005 reporting period. Approximately 69% of all applications resulted in a loan origination. Moreover, the reporting credit unions denied fewer than 13% of all applications. Of the total applications processed, 11.90% resulted in a denial of credit and 1.06% resulted in a denial of a request for pre-approval of credit.

Credit unions are also serving underserved areas with mortgage products. When credit unions complete the loan/application registers, they identify the location of the properties under consideration by census tract. The HMDA data compares the income levels of the census tracts of the properties under consideration to the income levels of the larger metropolitan statistical areas (MSA) that encompass the properties. NCUA uses a similar methodology when determining, for the purposes of chartering policy, if an area qualifies as underserved. An area with a median family income level at or below 80% of the median family income for the larger metropolitan statistical area is underserved.

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[11] These laws also apply to privately insured credit unions.
[12] NCUA is responsible for HMDA data collection for federally insured and privately insured credit unions.

Census tract income information was available for approximately 90% of the mortgage loan applications reported. For underserved areas, 66% of mortgage loan applications the credit unions processed resulted in originations, with fewer than 18% of the mortgage loan applications that included property in underserved areas denied. The approval rate in areas for mortgage loans in non-underserved census tracks was 75%, with only approximately 10% denied.

During 2005, reporting credit unions originated over 72,000 mortgages, with 13.5% of those originations occurring in underserved areas. The median family income reported by the applicants who received mortgages in underserved areas was $55,000. [13] In contrast, the median family income for applicants who received mortgages in areas that did not qualify as underserved was much higher at $72,000.

IV. NCUA and Federally Insured Credit Union Outreach

The NCUA and the credit union industry have historically devoted resources to addressing the homeownership needs of disadvantaged communities. Federally insured credit unions assist members in making the transition to homeownership by providing affordable loans and financial homebuyer education. NCUA has implemented several programs to encourage federally insured credit unions to expand homeownership opportunities and provide financial education to members.

A 2005 study by the Annie E. Casey Foundation indicated that the single most important step that could be taken to strengthen home ownership opportunities and retention among very low-income families is to expand and improve the delivery of financial literacy education and homeownership education and counseling. [14] In addition, the study states that the sharp growth of subprime lending in recent years appears to have increased the need for homeownership education while simultaneously making it more difficult for homeownership education groups to reach clients.

NCUA is a member of the Financial Literacy and Education Commission (the Commission), a federal entity established under the Financial Literacy and Education Improvement Act, enacted by Title V of the Fair and Accurate Credit

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[13] Median family income reflects the income level at which half of all families earn more, and half earn less. The American Community Survey defines a family as "a householder and one or more people living in the same household who are related by birth, marriage, or adoption." See *American Community Survey.* U.S. Census Bureau. <http://factfinder.census.gov /home/saff/main. html?_lang=en>.

[14] "Strengthening the Ladder for Sustainable Homeownership," prepared by the National Housing Conference for the Annie E. Casey Foundation, February 2005, page 18. The Foundation was established in 1948. The Foundation's stated mission is to foster public policies, human service reforms, and community supports that more effectively meet the needs of today's vulnerable children and families.

Transactions Act of 2003, to improve financial literacy and education of persons in the United States.

The principal duties of the Commission include: (1) encouraging government and private sector efforts to promote financial literacy; (2) coordinating financial education efforts of the federal government, including the identification and promotion of best practices; (3) the development of a national strategy to promote financial literacy and education among all American consumers; (4) the establishment of a website to serve as a clearinghouse and provide a coordinated point of entry for information about federal financial literacy and education programs, grants, and other information; and (5) the establishment of a toll-free hotline available to members of the public seeking information about issues pertaining to financial literacy and education.

In addition to serving as a member of the Commission, NCUA Chairman Johnson has served as Chairman of its MyMoney.gov website subcommittee since October 2006. The MyMoney.gov web site was created to provide public access to financial education tools and resources, which will empower Americans to save, invest and manage money wisely to meet personal goals. In this role, the Chairman coordinates the efforts of twenty federal agencies to improve financial education across the nation.

The Access Across America initiative, announced in February 2002, incorporated the Agency's activities for federally insured credit unions expanding services into underserved areas. The program has been designed to partner with federal government agencies and other organizations to identify and facilitate the use of resources available for federally insured credit unions to assist in their efforts to serve individuals in underserved areas.

As an adjunct to the Access Across America initiative, the Partnering and Leadership Successes (PALS) program was introduced in 2003 to provide best practices in serving members and marketing to potential members in underserved areas and communities. The agency coordinated widely attended workshops where a mix of federally insured credit unions presented programs focused on serving those in the lower economic strata. These programs included partnering opportunities with the Neighborhood Reinvestment Corporation, Latino outreach, and micro-business lending opportunities with the Small Business Administration. NeighborWorks® America is a national nonprofit organization created by Congress to provide financial support, technical assistance, and training for community-based revitalization efforts. There are 22 credit unions participating on NeighborWorks® Boards and Committees.[15] NCUA has incorporated the most successful aspects of PALs into the Access Across America programs and plans to continue to offer these valuable efforts in the future.

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[15] "Credit Union Partnerships With NeighborWorks Organizations: Proven Models for Success" booklet released jointly by NCUA and the National Reinvestment Corporation in 2002.

NCUA's Office of Small Credit Union Initiatives (OSCUI) conducts regional and national training workshops on a variety of topics to help small and low income designated credit unions (LICUs) succeed.[16] For example, in 2006, OSCUI held 20 national workshops covering subjects such as establishing financial literacy programs. Approximately 1,900 federally insured credit union representatives from 1,060 federally insured credit unions attended these workshops. NCUA plans to host another twenty workshops for 2007. Marketing to potential members and developing products designed for low- to moderate-income members will be discussed at this year's workshops.

In addition to the training, NCUA administers the Community Development Revolving Loan Fund (CDRLF) program. The CDRLF is funded through Congressional appropriations and provides financial assistance for federally insured credit unions serving predominantly low-income members. This financial assistance may be in the form of loans or technical assistance grants (TAGs). TAG initiatives are broadly structured so that LICUs may create outreach programs that meet their communities' needs. Although NCUA's grant initiatives do not specifically address foreclosure prevention, several approved TAG initiatives have been for the purpose of wealth building and financial education, which includes lessons about saving and being prepared for unexpected expenses, managing credit, budgeting, and purchasing a home.

Financial education and member outreach programs directly or indirectly prepare credit union members and the community for long-term homeownership, while avoiding foreclosure. NCUA has approved TAGs for federally insured credit unions that focus on this preparation. For example, Syracuse Cooperative Federal Credit Union, recipient of a TAG, offers financial education workshops in two languages addressing homeownership, qualifying for a mortgage, and building credit. The credit union also uses financial advisors who help members avoid foreclosure by providing housing counseling and access to mortgage lenders, realtors, or legal advisors. Another TAG recipient, Shiloh of Alexandria (VA) Federal Credit Union, provides a financial counseling program that addresses debt consolidation and credit awareness. The objective of the program is to provide affordable homeownership options to lower income individuals by providing down-payment and closing cost assistance and below-market interest rates on loans. These important initiatives, as well as loans to offset low-cost mortgage loans for the underserved, continue to receive support from the CDRLF.

Another way federally insured credit unions make mortgage products accessible and affordable to low-income consumers is to partner with government entities that provide assistance. Some federally insured credit unions that are certified by the U.S. Department of the Treasury's Community Development Financial

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[16] CDFI award profiles and financial assistance amounts are as of March 8, 2007.

Institutions (CDFI) Fund are recipients of awards.[17] These awards assist in defraying the costs of serving disadvantaged communities. The following are examples of the work performed by CDFI credit unions:

- The People's Community Partnership Federal Credit Union, located in Oakland, California, is a CDFI and an NCUA low-income designated credit union (LICU)[18]. CDFI assisted the credit union by providing funds to support classes on budgeting, banking, credit, and home buying to their predominantly minority membership. NCUA also provided a grant to the credit union to provide free tax return service for some low-income members.

- Latino Community Credit Union (LCCU) is a CDFI and LICU located in Durham, North Carolina. Its mission is to "improve the financial condition of the Hispanic community through the delivery of affordable financial services and financial education programs specifically targeted to underserved Hispanic immigrants in North Carolina."[19] The CDFI Fund has awarded $2 million to cover a portion of the cost to support a new branch, enhance delivery of services, and to implement a home mortgage lending program for new Latino immigrants, who make up over 85 percent of LCCU's membership.

- Self-Help Credit Union is a CDFI and LICU located in Durham, North Carolina. Its mission is directed toward "creating ownership and economic opportunity for minorities, women, rural residents, and low-wealth families." The credit union offers a variety of residential mortgage products and specializes in serving customers who cannot obtain conventional financing due to credit or other problems, and individuals who have traditionally been underserved, including female-headed, minority, and low-income households, rural families, and first-time buyers[20]. The credit union's bilingual financial education workshops include a home buying topic. Self-Help was awarded two grants from the CDFI Fund to help defray the costs of offering homeownership loans and other loan products in its service area.

In addition to a partnership with government entities, credit unions partner with other entities to offer Individual Development Accounts (IDAs). IDAs are savings

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[17] The CDFI Fund provides financial and technical assistance awards in order to promote access to capital and local economic growth in urban and rural low-income communities across the nation. A CDFI is "a specialized financial institution that works in market niches that are underserved by traditional financial institutions" and include regulated institutions such as community development banks and credit unions, and non-regulated institutions such as loan and venture capital funds.

[18] A LICU has a membership consisting of 50 percent or more low-income members.

[19] Credit union mission and product description from Latino Community Credit Union. 8 Mar. 2007.<http://cooperativalatina.org>.

[20] Credit union mission and product description from Self-Help Credit Union. 8 Mar. 2007. <http://www.self-help.org>.

accounts designed to assist low-income people on their path toward asset ownership through matched savings and financial education. Credit unions partner with local organizations to provide IDA programs with different goals.

Examples include:

- Alternatives Federal Credit Union (Alternatives) is a CDFI and LICU located in New York, New York. Its mission is "to build wealth and create economic opportunity for underserved people and communities." Alternatives began offering IDAs in 1998. It partners with local organizations (Challenge Industries, Tompkins Community Action and Department of Social Services) to provide IDA programs, each with different goals, savings matches and eligibility requirements. The CDFI Fund awarded funds to support its affordable housing loan activities. In addition to the partnerships mentioned, the credit union has a partnership with Ithaca Neighborhood Housing Services.[21]

- Fort Campbell Federal Credit Union located in Clarksville, Tennessee, created the Home Front Mortgage Program to help active duty military personnel stationed at Fort Campbell buy houses in Tennessee or Kentucky by eliminating down payments. First-time home buyers attend free homeownership counseling provided by BALANCE, a financial education and counseling service. The counseling can be done at any time as long as it is completed by the time the loan closes.

- O.U.R. Federal Credit Union is a CDFI and LICU located in Eugene, Oregon. The credit union targets its mortgage products and services to low-income micro entrepreneurs, Latino residents, and other Lane County, OR residents. The CDFI Fund awarded multi-year financial assistance that covered a portion of the cost of outreach to the Hispanic residents, a financial education program, affordable loan programs and development of a new mortgage loan program. United Way also assists the credit union in serving low-income persons. The credit union is a HUD-approved housing counseling agency.

- Community Trust Credit Union is a CDFI and LICU located in Modesto, California. Its products and services are directed toward "people who are traditionally underserved by mainstream financial institutions."[22] The credit union partners with many community based organizations that include the California State University, United Way, Hispanic American Society, and Council for the Spanish Speaking, to extend financial services to the underserved. The CDFI Fund has awarded the credit

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[21] "Credit Union Partnerships With NeighborWorks Organizations: Proven Models for Success" booklet released jointly by NCUA and Neighborhood Reinvestment Corporation in 2002.
[22] Credt union mission and product description from Community Trust Credit Union. 8 Mar. 2007. <http://www.myctcu.com>.

union with funds to open a new branch in a "neighboring community with very high levels of poverty and unemployment, in order to provide affordable financial services to currently un-banked individuals"; acquire technology and equipment to serve the community; and improve the delivery of its services.

Non-CDFI, non-LICU, federally insured credit unions also work to provide education and easier access to homeownership for their members. Following are a few examples of how large credit unions work with other entities or utilize their resources to aid with member education and initial down-payments:

- Reliant Federal Credit Union partnered with the State of New York Mortgage Agency (SONYMA) to offer affordable mortgage loans to first-time home buyers. The SONYMA Partnership Program offers low down payment requirements, flexible underwriting requirements, interest rate lock-in periods that are longer than conventional lock-in periods, and closing cost assistance. As part of this program, the member is required to complete a financial education course through a SONYMA approved source.

- Hiway Federal Credit Union, located in St. Paul, Minnesota, provides their members not only with affordable housing, but with sustainable housing by offering loans members can afford under Fannie Mae's (FNMA) "My Community Program." The credit union has also partnered with Lutheran Social Services (LSS) which has offices throughout the state to provide instruction on credit scoring and how the members can improve their credit scores. If a member's mortgage application is denied due to poor credit, the member receives two free counseling sessions with LSS. Members that complete the LSS program may be approved for a mortgage loan.

- Royal Credit Union, located in Eau Claire, Wisconsin, was recognized by the Wisconsin Housing and Economic Development Authority (WHEDA) and is in the top ten in the state for WHEDA loans. In 2006, Royal assisted 166 families participating with WHEDA. The credit union also uses other programs to help their members with home ownership including programs from Federal Home Loan Mortgage Corporation (Home Possible Program) and Veterans Administration programs. The credit union also conducts various home buyer seminars throughout the year to teach members about the steps necessary for home ownership.

- Goldenwest Federal Credit Union, located in Ogden, Utah, is a major participant in the Utah Housing Finance Agency's first time home buyer mortgage program. Under the program, first time home buyers, single parents, and members who have not owned a home in three years are eligible to participate. The credit union also participates in an "Own in Ogden" program that provides a down payment of up to $6,000 for homes located in low-income areas and in the "Good Neighbor Next Door

Program" which allows firefighters, policemen and school teachers to buy a U.S. Department of Housing and Urban Development foreclosure at 50 percent of value. In 2006, the credit union originated over 67 loans totaling $7.1 million in the programs.

- Navy Federal Credit Union, located in Merrifield, Virginia, focuses on ensuring that their military members are provided financial services throughout the world. On their website, they have a step-by-step process to assist members with determining how much they can afford to borrow. In addition, there is a short video on the website explaining the home buying process. The credit union also provides free mortgage counseling and a variety of mortgage loan products to suit the individual needs of its members, whether they are first-time or experienced home buyers. Additionally, they maintain the servicing of their members throughout the lifetime of the loan. This allows Navy Federal to help its members as they encounter special circumstances.

- Police and Fire Federal Credit Union, located in Philadelphia, Pennsylvania, offers a "lender-assist" mortgage which is designed for members with a minimal or no down-payment. This mortgage product provides members assistance of one percent of the loan amount to be applied toward closing costs. Additionally, the credit union has partnered with the Consumer Credit Counseling Service of Delaware Valley to provide members with access to free confidential credit counseling and debt management planning.

- Redstone Federal Credit Union, located in Huntsville, Alabama, offers first time home buyers the opportunity to obtain a grant from the Federal Home Loan Bank of Atlanta for down payment and closing assistance. The credit union offers real estate loans with a loan-to-value ratio of up to 100 percent utilizing programs sponsored by FNMA and USDA. Redstone FCU participates in the North Alabama Individual Development Account Program sponsored by Family Services and Department of Health and Human Services for low income families that are not immediately ready for homeownership, including many with past credit problems or first time homebuyers. This program allows families to save for a down payment with matching funds up to $6,000. The credit union provides financial counseling services for all homeownership loans.

- ESL Federal Credit Union, located in Rochester, New York, offers a "No-Down Mortgage Loan" and a "Low-Down Mortgage Loan" which finances up to 97 percent of the purchase price and a "Neighborhood Solution" loan with no down payment or low-down payment options. Additionally, the credit union offers a "No Closing Cost Mortgage" program which allows financing up to 95 percent on fixed or adjustable rate loans.

V. Consequences of Subprime Mortgage Market Dislocation for Federally Insured Credit Unions

While certain segments of the broader mortgage market have experienced record levels of mortgage foreclosures, federally insured credit union foreclosure rates remain relatively low. As of December 31, 2006, the national 30 day mortgage delinquency rate on 1-to-4 family residential properties was 4.95% of all outstanding mortgage loans and 1.19% of outstanding mortgages were in the foreclosure process.[23] Conversely, federally insured credit union mortgage delinquencies over 30 days totaled only 0.99% of all federally insured credit union mortgages and only 0.07% of outstanding federally insured credit union mortgages were in the foreclosure process.

Federally insured credit union mortgages are performing well in relation to the broader mortgage market, but NCUA is concerned about the "ripple effect" of the dislocation to the subprime mortgage market on federally insured credit unions and credit union members. As the number of consumers experiencing difficulty with housing payments increases, federally insured credit unions may be adversely impacted by rising delinquencies in both second mortgage loans and other consumer credit delinquencies.

At the end of 2006, asset quality in federally insured credit unions was at the best year-end level in six years. Overall delinquency improved from a high of 0.82% in 2001 to 0.68% of loans, while the net charge-off to average loans ratio improved from a high of 0.56% in 2003 to 0.45%. Meanwhile, federally insured credit unions' net worth to assets ratio grew to 11.54%, its highest level in six years. With federally insured credit unions exhibiting strong and improving asset quality, sound levels of net worth, and relatively limited involvement with subprime mortgages, NCUA is cautiously optimistic about federally insured credit unions' positioning with regard to the current subprime mortgage market dislocation.

VI. Conclusion

Federally insured credit unions originate and retain a relatively small amount of nontraditional or subprime mortgages. Federally insured credit union mortgage lending makes up only a small part of the overall mortgage market, and is predominantly comprised of more traditional fixed rate mortgages. Some federally insured credit unions offer nontraditional mortgage products or risk based lending programs as a means of reaching underserved members who otherwise would not qualify for loans. NCUA has outlined safe and sound

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[23] According to the Mortgage Banker's Association's (MBA) *National Delinquency Survey* issued 3/13/07 with data as of 12/31/2006. The MBA's *National Delinquency Survey* is based on a sample of over 43 million mortgage loans serviced by mortgage companies, commercial banks, thrifts, and credit unions. Typically, federally insured depository institutions have lower delinquency rates than the overall national 30 day delinquency average.

lending practices for these types of loan programs and carefully monitors mortgage lending performance indicators in individual federally insured credit unions and the industry. Current federally insured credit union mortgage performance is indicative of sound underwriting and appropriate collection efforts in federally insured credit unions. To date, NCUA has not noted an unsound level of mortgage loan delinquency, net charge-offs, or foreclosures in federally insured credit unions. Through its examination process, NCUA ensures federally insured credit unions have collection policies and procedures in place to deal with any increase in foreclosures and work with members to return them to a current status where possible.

NCUA continues to support the recent Interagency Guidance on Nontraditional Mortgage Products, and views it as a key step in addressing the general weakening of underwriting standards in the overall mortgage market. While, in NCUA's assessment, nontraditional mortgage products are not prevalent in federally insured credit unions, the guidance sets forth best practices and information valuable to credit unions that may offer these products. NCUA also recognizes the possibility that federally insured credit unions and their members could also be negatively affected by nontraditional mortgage loans granted outside of federally insured credit unions in the broader mortgage market. To that end, NCUA has an interest in ensuring these loans are prudently underwritten and clearly understood by borrowers wherever they are offered.

NCUA also supports the recently proposed Interagency Guidance on Subprime Mortgage Lending. While subprime lending in federally insured credit unions is normally part of a broader risk based lending program, the underwriting standards proposed by the guidance are prudent and consistent with the message NCUA has been conveying to federally insured credit unions for years. Loans to subprime borrowers must be underwritten prudently and should not be granted to the borrower's detriment. It is critical that subprime mortgage borrowers be given timely information to ensure they understand the risks involved with the products they select. NCUA will work with the other agencies to finalize this important guidance as soon as possible.

Attachments

I. NCUA Letter to Credit Unions 174

II. NCUA Letter to Credit Unions 99-CU-05

III. NCUA Letter to Credit Unions 04-CU-13 with attached Subprime Questionnaire

IV. NCUA Letter to Credit Unions 05-CU-15 with attached 10-06 Supervisory Alert

V. NCUA Letter to Credit Unions 06-CU-16

NATIONAL CREDIT UNION ADMINISTRATION
NATIONAL CREDIT UNION SHARE INSURANCE FUND
LETTER TO CREDIT UNIONS

LETTER NO. 174 DATE: August 1995

DEAR BOARD OF DIRECTORS:

In an effort to expand their ability to make more loans, many credit unions have begun risk-basing their loans.

Credit unions should engage in risk-based lending, not as a means of re-pricing existing balance sheets, but as a tool to reach out to the under-served and take a risk that might otherwise be avoided. Risk-based lending involves setting a tiered pricing structure that assigns loan rates based upon an individual' s credit risk. Through a carefully planned risk-based lending program, credit unions may be able to make loans to somewhat higher-risk borrowers, as well as better serve their more credit-worthy members.

Attached is an informational white paper, which is intended to present a balanced view of the advantages, as well as potential pitfalls, of risk-based lending. This paper is not intended to be all-encompassing. However, it does provide adequate reference material to help you determine whether a risk-based lending program may be appropriate for your credit union.

Safety and soundness should remain of paramount importance when considering any new program and throughout the life of any program. Risk-based lending may be appropriate for credit unions with financially sound operations. If you have any questions after reviewing the attached paper, you should contact your district examiner.

Norman E. D' Amours
Chairman of the Board

Enclosure
FCU

NCUA INFORMATIONAL WHITE PAPER

This paper is for informational purposes only and is not intended to endorse any one method of credit underwriting. Credit unions are strongly encouraged to consult legal counsel prior to implementing new lending policies, products, or programs.

I. RISK-BASED LENDING

A. Introduction

Risk-based lending allows credit union management to assess the risks involved in different types of loan products and price these products based upon the inherent risk associated with individual borrowers. The end result is a more diversified loan portfolio mixing lower-yielding, lower risk loans with higher yielding, but riskier loans. Prior to beginning a risk-based lending program, it is important that the credit union board determine the parameters for the riskier loans based on the credit union' s financial condition, business plan, lending and collection history, and asset liability management (ALM) program.

Risk-based lending philosophy does not intend for a credit union to grant "bad loans," however, it assumes that proper pricing and conservative terms may justify higher risk loans. Credit unions offering risk-based lending should aim towards diversification and management of risk. This can be accomplished by establishing policies, procedures, and pricing ranges broad enough to serve low risk, average, and higher-risk borrowers. The key to successful risk-based lending is to ensure that prices (rates) correctly reflect the risk and costs involved. Risk-based lending is not suitable for every credit union and the financial and operational issues involved should be fully explored prior to entering a RBL program.

Often risk-based loans are referred to by terminology such as "Credit Rebuilder," "Lend a Hand," or "Fresh Start" for the higher risk categories, "Standard Rate" for the average risk loans, and "Reward," "Gold/Platinum," or "Grade A" for the lowest risk categories. References to higher risk loans that have negative connotations such as "High Risk Member" or "Below Average Borrower" should be avoided.

The credit union can become the lender of choice for all members by offering the best possible rate based upon each individual' s credit history. The less creditworthy members benefit by qualifying for a loan with their credit union instead of resorting to higher-cost alternatives such as finance companies and auto manufacturers. On the other hand, members with good credit histories can qualify for lower rates without being forced to turn to other institutions or financing sources that may offer lower rates to qualifying applicants.

B. Advantages of Risk-Based Lending

- Provide service to a greater number of members (including those with limited economic means)
- Can be used for various types of loans (installment, lines of credit, credit cards, real estate, etc.)
- Enhances the ability to offer individualized service and credit counseling
- Allows marginal borrowers to improve credit-worthiness and credit history
- Increases ability to cross-sell and extend service relationships
- Improves image of the credit union
- Improves the credit union' s competitive advantage
- Increases the flexibility of loan policy to accommodate the broad-based needs of its membership
- May increase loan volume
- May improve asset diversification
- Increases income to cover increased costs associated with greater risks (if loans are correctly priced)

- Promotes management of risk versus minimization of risk

C. Possible Disadvantages

- Requires restructuring of lending policies
- Requires significant training and education of credit union officials, management, staff, and members
- Demands close attention to consumer compliance issues
- Requires maintenance and periodic re-evaluation (validation of criteria)
- May result in increased delinquency, loan losses, collection costs
- Involvement may be limited based upon available liquidity and funds management considerations
- May result in uncontrolled loan growth
- May result in inappropriate application of lending policies

D. Consumer Compliance Issues

All loans are subject to various regulations and laws designed to protect the consumer. Regulation B (Equal Credit Opportunity Act - ECOA) and The Fair Housing Act (FHA) are specifically designed to regulate the lending industry to make credit equally available to all creditworthy borrowers. These laws prohibit discrimination against applicants based on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract), receipt of public assistance income, or the exercise in good faith of any right under the Consumer Credit Protection Act. In addition, the FHA prohibits discrimination on the basis of familial status and handicapped status. To run a successful risk-based lending program, as with any loan program, compliance with ECOA, FHA, and The Fair Credit Reporting Act (FCRA), as well as any other applicable laws or regulations, must be ensured.

The ECOA encompasses all aspects of a credit transaction (such as advertising, inquiries, the application process, administration of accounts, the treatment of delinquent accounts, collection practices, etc.). Credit unions must avoid potentially discriminatory practices throughout the life of the loan.

Risk-based lending consumer compliance requirements are no different than the consumer compliance requirements for traditional lending programs. However, when embarking upon a risk-based lending program, credit unions should be highly cognizant of the three key analyses that courts have identified for proving discrimination under ECOA. These factors are:

(1) Overt Discrimination occurs when a lender blatantly discriminates on a prohibited basis.

(2) Disparate Treatment includes overt, as well as more subtle disparities in treatment resulting from treating applicants differently on a prohibited basis. This is more likely to occur when dealing with marginally qualified applicants and is sometimes referred to as the "quality of assistance" provided to an applicant. **A difference in treatment, not proof of prejudice or a conscious intent to discriminate, is required to be shown.**

(3) Disparate Impact can be shown when a practice is applied consistently to all applicants, but the practice has a discriminatory effect on a prohibited basis that is not justified by business purpose. Disparate impact is most likely to occur as a result of use of a long-standing written policy or procedure.

The "effects test" is used to determine disparate impact. This test measures whether a credit practice, while on its face is neutral and is applied equally, has a disproportionately negative effect (disparate impact) of discriminating against a protected class. For example, a lender' s policy not to extend credit to applicants that change jobs three or more times during a two-year period, while facially neutral, may disproportionately exclude minority applicants from obtaining loans. To justify such a policy, a lender would be required to prove a business purpose for the policy and that no less discriminatory alternative is available.

Credit practices must be justified by business purpose and must be considered reasonable. If the business purpose standard is met and a less discriminatory alternative is not available, the use of the policy or practice may be defended. This area of the law is evolving and specific guidelines given today may change tomorrow. A well-documented system of underwriting, combined with periodic re-testing of the criterion is encouraged to avoid violating the effects tests.

Reasonableness of the creditworthiness criteria derived must be periodically re-tested. Frequency of testing will be dependent upon the accuracy of the original assumptions. To ensure reasonableness, credit and pricing decisions should be supported by:

1. Actual experience with loans having similar characteristics,
2. An empirically derived, demonstrably sound statistical analysis;
3. Industry-wide data available from outside credit services,
4. A well-documented estimate of the servicing, counseling and collection costs.

Credit unions can reduce the chance of fair lending violations by establishing sound policies and procedures, as well as proper employee training and supervision. Credit unions may implement "self-testing" procedures. "Self-testing" occurs when a lender arranges for "testers" or "shoppers" to pose as loan applicants to determine how applicants are treated by the credit union employees.

To encourage fair lending self-testing, the National Credit Union Administration will not ask credit unions to disclose the results of their self-testing programs. Self-testing, identification, and corrective actions do not eliminate legal liability or insulate the lender from lawsuits, or enforcement actions. They could, however, be considered to be substantial mitigating factors in determining the nature of any enforcement action and what penalties or other relief would be appropriate.

A credit union may also perform a self-assessment of its risk-based lending program. Self-assessments can be completed internally or by outside consultants/specialists. The self-assessment process involves comparative file reviews, interviews with key employees, policy/procedure review, etc.

In addition, strict compliance with adverse action notice rules of Regulation B (ECOA) and the Fair Credit Reporting Act (FCRA) is required. The ECOA requires that the lender specifically disclose the principal reasons for denial or other adverse action. The FCRA requires the lender to disclose when it has based its decision, in whole or in part, on information from a source other than the applicant or from its own files (i.e., credit scoring system). Notice requirements vary with the situation and credit union management is responsible for proper implementation. Generally, the disclosure of the principal reason(s) for denial or other adverse action will depend upon the credit evaluation system used by the lender (credit scoring, judgmental, or combined).

Other compliance issues that should be considered prior to implementation include Regulation Z (Truth-in-Lending) requirements governing disclosures and advertising, the Credit Practices Rule (part 706 of

the NCUA Rules and Regulations), the Home Mortgage Disclosure Act, and the Federal Fair Housing Act.

The opinion of legal counsel is recommended prior to implementation of a RBL program, as well as when material revisions are made, to ensure that the credit union' s policies and practices comply with applicable laws and regulations. The opinion obtained should not merely reiterate the regulations, but should specifically state that the credit union' s policy does not violate fair lending regulations.

The credit union may be insured against consumer compliance related losses by its surety bond if the appropriate rider has been purchased. The credit union may request that the insurer complete a risk evaluation review of its lending programs to further ensure compliance.

E. Important Considerations

Credit unions must do their homework*prior* to implementing risk-based lending. The planning phase should be documented and retained by the credit union for future use during the monitoring and evaluation phase of the program. The following are some points to consider during the planning and development phase:

- Involve staff in the planning and development phase to ensure understanding and communication of the risk-based lending philosophy.

  Train staff to counsel members from initial application through the loan closing to ensure thorough understanding and emphasize timely repayment.

- Plan to service higher risk borrowers, while attracting and retaining low-risk, high quality loans, by setting and adjusting rates accordingly.

- Plan to service higher risk borrowers, while attracting and retaining low-risk, high quality loans, by setting and adjusting rates accordingly.

- Consider beginning a risk-based lending program with a single loan product or establish a limited "test phase" to work out bugs and evaluate the system.

- Consult legal counsel and obtain an attorney' s opinion on the program prior to implementation.

- Consider the effect of interest rate and liquidity risk, as well as credit risk.

- Prepare an initial marketing plan which addresses the members' loan needs.

- Establish maximum loan amounts and terms, in addition to loan pricing, to ensure that portfolio risk is properly managed.

- Obtain board approval.

II. PLANNING, POLICIES, PROCEDURES, MONITORING

A. Planning Phase

(1) Membership Needs

Who are the credit union' s members and what is their financial status? Credit unions must first consider if their members' needs will be better served by instituting risk-based lending. A review of rejected loan applications may reveal that risk-based pricing would have allowed a number of these loans to be made.

A member survey may also assist management in deciding whether to implement a risk-based lending program. Through surveys, credit unions can analyze whether members are obtaining loans from alternative financing sources when they do not qualify for a credit union loan or find cheaper credit elsewhere.

(2) Staffing/Training Needs

Staffing levels must be adequate to handle loan underwriting, processing, follow-up, and collections. The credit union should anticipate and plan for increased credit counseling.

To have an effective program, staff must understand the philosophy of risk-based lending. Training on consumer compliance regulations and risk-based lending underwriting must be provided prior to implementation and on an ongoing basis. Initial staff involvement in the planning phase can help ensure that the fundamentals of risk-based lending are understood and accepted.

(3) Financial Condition of the Credit Union

Officials must determine that the financial condition of the credit union is strong enough to support a risk-based lending program. Ongoing analysis in this area is necessary to effectively evaluate the success of the program.

At a minimum, officials should consider the following issues:

- Is risk-based lending consistent with the credit union' s mission?
- Does risk-based lending fit into the credit union' s goals, objectives, and strategic plan?
- Is capital adequate to absorb potential increased losses? What is the maximum percentage of capital that can be devoted to higher risk loans?
- What additional reserving needs may be required?
- Is asset quality acceptable and is diversification needed? What is the maximum percentage of assets that can be earmarked for higher risk loans?
- Are delinquency levels reasonable and to what extent are they expected to increase?
- Are loan losses at a reasonable level and to what extent can the credit union afford to increase losses? How much are loan losses expected to increase?
- Are operating expenses reasonable and what, if any, increases can be expected from this program (i.e., training costs, legal opinions, collection costs, etc.)?

- What are the expected start-up costs?
- Can risk-based lending generate sufficient income to cover the cost of servicing, administration, collections, and loan losses (analyze costs/benefits)?
- Will an outside consultant be needed to assist with training and development of the program and what costs would be associated with this alternative?
- Does the credit union have adequate liquidity to increase lending? Is loan participation a viable option when liquidity is limited and loan demand exists?
- Does an adequate ALM program exist and how does this new product fit in? Can officials ensure that they will not have to rely upon high-rate, volatile shares as a long-term liquidity source?
- Are share rates reasonable and can loans be marketed at reasonable rates to maintain an adequate spread?

(4) Operational Issues

Officials must determine that the credit union is operationally ready to undertake a new program. Board approval of the program should be documented in the minutes. Resources should be evaluated to determine whether additional or outside assistance is needed (or could be beneficial).

At a minimum, officials should consider the following:

- Does unfulfilled loan demand exist?
- Is membership stability a problem?
- Are members forced to go to the competition to obtain loans that the credit union could possibly grant? Can the credit union fill this need while maintaining safe and sound operations?
- Are resources available to ensure adequate staffing, training, and marketing?
- Can the existing reporting systems provide for ongoing monitoring (by collateral or type code)?
- Can existing collections systems adequately track and evaluate the success of the program?
- Are internal controls adequate to ensure compliance with regulations, policies, pricing, etc.?
- Under what conditions would officials consider termination of this program? Can reasonable risk thresholds be established?

B. Establishment of Policies/Procedures/Quality Controls

Following completion of a cost-benefit analysis, the development of sound policies, procedures, and quality controls are fundamental to the success of any new product. Policies, procedures, and quality control measures must be documented. Communication of the policies and procedures through employee involvement and training should start during the planning phase.

Quality control measures may include, although are not limited to, the following:

- Code loans by risk tier (1, 2, 3 or A, B, C) and monitor delinquency and losses by tier. At a minimum, code and track the highest risk tiers. Adjust criteria if delinquency or losses are unacceptable. Retain monitoring reports to support the business purpose of the criteria adjustment.

- Evaluate portfolio risk by tracking delinquency and performance of loans based upon the origination date.

- Analyze the net income contribution of each tier of the portfolio prior to implementation and quarterly thereafter to determine whether loans are priced appropriately and fairly.

- Evaluate all rejected applications (i.e., some applications that are rejected by a scoring system may not measure true credit-worthiness).

- Review performing loans after a specified period (i.e., 6-12 months) and upgrade to lower rates when repayment and credit performance places the borrower into a new tier.

- Closely monitor member complaints for signs of potential discrimination or problem employees.

- Re-evaluate the risk-based lending policies, procedures, and overall program periodically and retain documentation of the evaluation process.

- Conduct a self-assessment to review overall program compliance. A self-assessment may be performed internally or through the use of outside consultants.

- Consider a "self-testing" program to evaluate the treatment of applicants.

(1) Maximum Limits

Based upon the credit union' s financial condition, officials should establish a policy maximum (dollar and/or percentage limits) on the higher risk loan tiers in relation to assets, loans, and capital. In addition, to ensure diversification, the credit union should establish the (1) maximum aggregate amount available to loan to higher risk borrowers and (2) maximum aggregate amount for each type of loan available for higher risk borrowers. A maximum loan dollar limit per borrower should also be established. An initial testing phase, with lower limits may be recommended to evaluate policies and procedures.

Risk-based loans must be tracked by the credit union to allow periodic evaluation of the program and established limits. Depending upon the data processing system available, a loan collateral code or type-code should be assigned during the loan processing for tracking and reporting purposes.

(2) Pricing/Advertising Considerations

Officials should strive to price loans competitively and reasonably in relation to risks, as well as the credit union' s financial condition.

At a minimum, loan pricing decisions should consider:

- Cost of operations (loan servicing, collections, overhead);
- Cost of funds;
- Anticipated loan losses;
- Risk premium (or discount);
- Desired/Required contribution to equity;
- Any associated loan fees (may be deducted from rate).

Advertising for risk-based loan rates must be carefully worded. Use of terminology such as "rates as low as X%" and clarification that the best rates are based "on approved credit" should help to avoid the perception of "bait and switch" advertising.

(3) Underwriting

Risk-based lending requires the establishment of underwriting guidelines for different levels of risk. Credit unions have the option of using a credit scoring system, judgmental review system, or a combination of both. Basically, there is no "one-size fits all" system for risk-based lending. The use of a numeric credit scoring system derived by an impartial third party (i.e., credit reporting agency) to remove any questions of discrimination, is favored by many. Once the method and criteria are established, they must be followed with no exceptions to policy in order to avoid potential ECOA or FHA violations.

(i) Credit Scoring Systems

By applying a risk rating system to information provided on the borrower' s application, credit scoring systems facilitate credit decision recommendations. Credit scoring systems consider factors such as debt to income ratio, credit history, job stability, amount of outstanding unsecured debt, residence stability, assets, collateral offered, etc. No prohibited basis may be used as a variable in a scoring system, other than age, which may serve as a predictive factor provided the age of an elderly applicant is not assigned a negative factor or value.

Credit scoring models must be based upon empirically derived, statistically sound methods of evaluating applicants. In general, the use of a properly derived credit scoring system reduces the possibility that loan policies may be discriminatory. A valid credit scoring system will not provide automatic protection or a "safe harbor" from a challenge. Scoring systems require regular monitoring, updating, and retesting to ensure reasonableness as the credit union' s portfolio changes.

Credit decisions can be made more quickly by computerized credit scoring rather than by judgmental review. However, in many cases, applicants that are rejected by credit scoring due to unusual circumstances will require subsequent review by an experienced loan officer.

Credit scoring systems can be custom-made for the individual credit union or based upon generic data. A custom-made scoring system develops evaluation criteria by analyzing the credit union' s portfolio and loan losses, and normally requires a sizable portfolio to be considered valid. If expertise is not available in-house, outside assistance is necessary. The cost of such a system through a third party vendor or

consultant will depend upon asset size. Since substantial time and financial costs may be incurred, a cost/benefit analysis is recommended.

Generic credit scoring systems are based upon a portfolio created from a sufficient amount of combined regional data to be considered a valid representation. While a custom system will be more accurate than a generic, since it is derived from an individual credit union' s data, generic systems are considered useful tools. Generic scoring systems are available through most of the large credit reporting service agencies.

(ii) Judgmental/Loan Officer Review Systems

In some cases, a scoring system is not practical for an individual credit union due to cost or other considerations. Any credit review system other than an empirically derived, demonstrably sound, credit scoring system is termed to be a judgmental review system. Judgmental review requires a well-trained loan officer. Consistent application of the credit union' s policies is of paramount importance. Policies must be clearly documented and a matrix may be used to determine risk and the appropriate price.

Judgmental reviews often consider such factors as debt to income ratio, disposable income, loan-to-value, credit report/history, etc., as well as other information obtained from the loan application. Training, quality control reviews, and continual re-evaluation of policies and procedures must be emphasized. Successful judgmental systems require the loan officer to clearly document the loan decision in the loan file.

(iii) Combined Review - Judgmental and Credit Scoring

A combination of the two types of review may provide the credit union with the best of both systems. For example, a combined review system could work by initially processing all applications through the credit scoring system to determine the appropriate risk tier. Applications with scores that meet or exceed the standard (or preferred) rate are approved. Applications that do not qualify for the standard or preferred rate then move on to a loan officer for judgmental review to determine whether the applicant qualifies for a lower tier (higher rate) loan.

The initial credit score is used as a guideline for tiered pricing decisions, however, loan officers are not restricted by the credit scores alone. Credit unions must have clearly written policies to equitably determine which pricing tier is appropriate for each applicant. To assist the credit union in the evaluation of its combined review system, the principle reasons why a credit-scored application was not eligible for the standard (preferred) rate, and was passed on to a judgmental review, should be documented in the loan file.

An adverse action notice may be required when the applicant is offered credit different from that which he or she originally applied for (counteroffer). If the applicant is denied credit based upon the judgmental review, the adverse action notice must reflect the component of the system that the applicant failed (credit scoring, judgmental, or both).

(4) Establish Thresholds for Discontinuance of Program

Risk evaluation thresholds that, if met, would require termination of the program should be established prior to implementation of risk-based lending. Thresholds for discontinuance could include delinquency and loan loss ratios, reduced capital levels, net losses from specific risk tiers, etc... Delinquency and loan

losses will not surface until the program has been in place for a number of months, therefore, close monitoring and evaluation is critical.

(5) Legal Opinion/Risk Review

Legal counsel should be obtained to review and comment on the credit union' s proposed risk-based lending program to ensure compliance with applicable laws and regulations.

In addition to legal counsel review, the credit union officials may want to request the surety bond company to complete a risk review of the risk-based lending program policies, procedures, and related internal controls.

(6) Monitoring and Follow-up

The credit union must establish a tracking mechanism to monitor performance of the risk-based portfolio by assigning computer codes based upon the loan risk tier. At a minimum, all of the highest risk category loans granted should be I tracked separately from the other loans in the credit union' s portfolio. The credit union' s tolerance for reasonable delinquency levels and loan losses must be considered based upon financial performance and operational issues.

Assuming that the portfolio will contain higher risk loans, reserve needs should be evaluated and considered up front. Eventually a historical loss ratio can be derived by tracking each risk category for reserving purposes.

Management must periodically evaluate both successful and unsuccessful aspects of the program and should revise or fine-tune the overall program as necessary to achieve accurate and valid information. Reports must be provided to the officials through these interim reviews. Quality control measures must be established. If a scoring system is utilized, periodic retesting is required. Retesting of risk rating assumptions recommended at least annually to ensure that the "effects test" is not violated. The objective of testing is to determine the best way to grant risk-based loans with the least discriminatory effect.

III. EXAMINATION PROCEDURES

A. Safety and Soundness Issues

The presence of a risk-based lending program will be noted in the examination report where deemed appropriate. In most cases, adoption of a risk-based lending program is not recommended for credit unions with sever operational problems.
Examiners will evaluate risk-based lending programs based upon materiality in relation to the financial and operational conditions of the credit union. Safety and soundness issues will be noted on the Loan Exceptions or Examiner' s Findings workpapers as appropriate. Records of Action to correct material deficiencies will be discussed and developed with officials prior to issuance of the final examination report.

Consumer regulation compliance will be addressed during the compliance review portion of the examination. Any potentially discriminatory practices that identified during the examination will require correction by the credit union.

The credit union' s policies and procedures must be well-documented. Quality control measures must be in place. Ongoing monitoring and re-evaluation by credit union officials is encouraged.

NCUA' s review of a risk-based lending programs will focus on safety and soundness issues, regulation compliance, full and fair disclosure, and risk management. At a minimum, examiners will review the following aspects of the risk-based lending program:

- Are Policies and procedures documented and comprehensive?
- Are policies and procedures followed?
- Are employees and officials properly trained?
- How well are overall risks managed?
- Are reasonable limits established for higher risk loans?
- Are loan decisions documented in the file?
- Are quality control measures adequate?
- Does the credit union have an adequate tracking system?
- Is the program periodically re-evaluated?
- Is delinquency monitored by loan tier?
- Are collections efforts appropriate, consistent, and timely?
- Does the credit union have a reasonable method for funding the ALL for higher risk loans?
- Is a credit scoring system being utilized and is the system periodically re-evaluated or re-tested to maintain predictive validity?

IV. GLOSSARY OF KEY PHRASES

Business purpose: (formerly "business necessity) To prove that a credit evaluation criteria meets a business purpose, there must be a demonstrable relationship between the criteria and an applicant' s level of creditworthiness. Business purpose may include such factors as minimization of the risk of losses, the control of operating and administrative expenses, and profitability. If a policy or practice is justified by business purpose and there is no less discriminatory alternative, a violation of the ECOA or the FHA will not exist.

Credit scoring system: A system that evaluates creditworthiness of an applicant based on key attributes of the applicant and aspects of the transaction. Such a system may be used, alone or in conjunction with

an evaluation of additional information about the applicant, to determine whether an applicant is deemed creditworthy.

Empirically derived, demonstrably sound (credit scoring system): For a system to qualify as such, the system must:

(1) be based upon data derived from an experimental comparison of sample groups or the population of creditworthy and noncreditworthy applicants that have applied for credit within a reasonably recent period of time-

(2) be developed for the purpose of evaluating the creditworthiness of applicants with respect to common business interests of the lender utilizing the system (i.e., such as minimizing loan losses and operating/administrative expenses);

(3) be developed and validated utilizing recognized statistical principles and methodology; and

(4) be periodically revalidated utilizing appropriate statistical principles and methodology and modified as needed to maintain predictive ability.

A credit scoring system obtained from an outside source must satisfy the above requirements. If the lender is unable to validate the system based upon its own credit experience as set forth above, the system must be validated when sufficient credit experience data becomes available. If the validity test is failed, the system can no longer be considered an empirically derived, demonstrably and statistically sound, credit scoring system for that lender.

Judgmental review system: Any system utilized to analyze creditworthiness other than an empirically derived, demonstrably sound, credit scoring system.

Prohibited basis: Includes race, color, religion, national origin, sex, marital status, or age (provided that the applicant can legally enter a binding contract)-, the fact that all or part of the applicant' s income is derived from public assistance; or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act or any state law upon which an exemption has been granted.

Self-testing: Testers or "shoppers" pose as loan applicants to determine how applicants are treated by credit union employees. Self-testing is one method that may be utilized to safeguard against potentially discriminatory practices.

NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: **June 1999** **LETTER NO.: 99-CU-05**

TO: **Federally Insured Credit Unions**

SUBJ: **Risk-Based Lending**

This Letter to Federally Insured Credit Unions provides guidance on managing the benefits and risks associated with risk-based lending. Other federal financial institution regulators recently issued similar guidance regarding what they term "subprime lending programs."

Risk-based lending is a means by which a credit union may be able to more effectively meet the credit needs of all its members. It involves setting a tiered-pricing structure that assigns loan rates based upon an individual's credit risk. Risk-based lending generally has the most significant benefit for two broad categories of borrowers:

- those attempting to "repair" their credit due to previous mishandling of credit (e.g., seriously past due credit, prior charge-offs, bankruptcy, etc.) and
- those attempting to establish credit (e.g., first time borrowers, borrowers with little credit history).

Although the rates paid by borrowers with less than perfect credit histories are higher than rates paid by borrowers with strong credit histories, these members are able to obtain loans without paying the excessive fees charged by many alternative "financial providers" such as finance companies, rent-to-own stores, title loan companies, and pawnshops.

Risk-based loans can be profitable, provided the rates charged by the credit union are sufficient to cover the loan loss rates and overhead costs related to underwriting, servicing, and collecting these loans. However, credit unions that cannot justify and support pricing differences based on risk will face heightened compliance and reputation risks if pricing decisions appear to result in disparate treatment under consumer protection regulations (e.g., the Equal Credit Opportunity Act).

Risk-based lending benefits borrowers with strong credit histories by providing them lower interest rates. A properly planned risk-based lending program rewards borrowers based on how they manage their credit histories. As a member's credit history improves, risk-based lending should recognize and reward the borrower's financial improvement. To work properly, risk-based lending requires:

- specialized expertise,
- sound planning, and
- reliable monitoring and control systems.

Risk-based lending is complex and requires well-honed credit granting skills. It can be a high-risk activity that requires additional due diligence to properly identify, measure, monitor, and control risk. Risk-based lenders may discover that they underestimated the default risks and associated collection costs. Credit unions should consider the additional risks inherent in risk-based lending and determine if these risks are acceptable and controllable given the credit union's staff, financial condition, size, and level of capital support. A well-conceived business plan that addresses those risks is necessary for credit unions in this activity to maintain safety and soundness.

It must be remembered that the purpose of credit union risk-based lending is to make loans available to members who might not qualify otherwise. Therefore, a properly structured risk-based lending program that meets their credit needs should bring new higher-risk borrowers into the credit union, and not merely result in the re-pricing of existing lending profiles.

Credit unions that engage in risk-based lending should have in place:

- strategic and business plans that acknowledge the additional inherent risks and provide for the necessary resources, including specialized management and staff expertise, to manage the risks;

- policies and procedures approved by the board that define the parameters of the risks assumed and internal controls necessary to ensure acceptable portfolio quality;
- information systems capable of providing monitoring information sufficient to analyze the results of underwriting, operations, and pricing decisions;
- quality control systems that provide feedback on the adequacy of and adherence to underwriting, operating, pricing, and accounting guidelines; and
- programs for rewarding risk-based borrowers who perform well.

The attached Appendix provides the credit union more detailed information regarding risk management issues it should address before embarking on a risk-based lending program.

Capitalization

Risk-based lending activities can present a greater demand on the credit union's capital and the National Credit Union Share Insurance Fund (NCUSIF); therefore, the level of capital a credit union needs to support this activity should correspond with the risks incurred. For most credit unions engaging in this activity, their current level of capital is sufficient. However, credit unions should keep in mind that the amount of capital necessary to maintain safety and soundness will vary according to the volume and type of risk-based lending pursued and the adequacy of the credit union's risk management program. Examiners will review the credit union's documentation of its method used to determine the amount of capital necessary, and will evaluate the overall capital adequacy on a case-by-case basis.

Examination Objectives

Due to the complexity and specialization associated with risk-based lending, examiners must carefully evaluate this activity during regular examinations and, if necessary, during supervision contacts. In reviewing risk-based lending programs, examiners will:

- evaluate the extent of risk-based lending activities;
- determine whether management adequately planned for this activity;
- assess whether the credit union has the financial capacity to conduct risk-based lending safely without undue concentration of credit and without overextending capital resources;

- ascertain if management has committed the necessary resources in terms of technology and skilled personnel to manage the program;
- evaluate whether management has established adequate lending standards and is maintaining proper controls over the program;
- determine whether the credit union's contingency plan adequately addresses issues that could arise during a period of an economic downturn or when financial markets become volatile;
- analyze the program's performance, including profitability, delinquency, and losses;
- consider management's response to adverse performance trends, such as higher than expected prepayments, delinquencies, charge-offs, and expenses; and
- determine if the credit union's compliance program effectively manages the fair lending and consumer protection compliance risks.

Sincerely,

/S/
Norman E. D'Amours
Chairman, NCUA Board

Appendix

Following are some essential risk management issues that a credit union should address before embarking on a risk-based lending program:

- Planning and Strategy. Credit unions instituting risk-based lending programs should proceed slowly and cautiously to minimize the impact of unforeseen personnel, technology, or internal control problems and to determine if favorable initial profitability estimates are realistic and sustainable. Before engaging in a risk-based lending program, the board and management should ensure that the program is consistent with the credit union's overall business plan and risk tolerances. Risk assessment should incorporate operating, compliance, and legal risks. Risk issues which credit unions involved in risk-based lending must address include:

    - attracting and retaining qualified personnel;
    - investing in technology necessary to manage a more complex portfolio;
    - lending solicitation and origination strategies that allow for after-the-fact assessment of the credit union's underwriting; and
    - establishing appropriate feedback and control systems.

- Staff Expertise. Risk-based lending may require staff to acquire specialized knowledge and skills in areas such as credit granting, marketing, pricing, loan origination, and collections. For most credit unions, supplementing staff training should be sufficient; however, some credit unions may find it necessary to hire additional staff. Servicing and collecting loans generated in risk-based lending programs can be labor intensive.

- Lending Policy. A risk-based lending policy should be appropriate to the size and complexity of the institution's operations and should state the goals of the risk-based lending program. The policy should, at a minimum, address the following lending standards:

    - types of products offered, as well as those that are not authorized;
    - portfolio targets and limits for each credit grade or class;
    - lending authority clearly stated for individual loan officers, supervisors, and credit committee;

- ◊ a framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative/servicing costs, expected charge-offs, and capital;
- ◊ collateral evaluations and appraisal standards;
- ◊ well-defined and specific underwriting parameters (i.e., acceptable loan terms, debt-to-income ratios, loan-to-collateral value ratios for each credit grade, and minimum acceptable credit score) that are consistent with applicable supervisory guidelines;
- ◊ procedures for separate tracking and monitoring of loans approved as exceptions to stated policy guidelines;
- ◊ credit file documentation requirements such as applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memoranda to support the loan decision; and
- ◊ correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards.

Credit unions that use credit scoring should adapt the scoring model for members targeted in a risk-based lending program. Frequent review and updating of credit scoring models will help ensure that the assumptions remain valid and that the credit union complies with applicable consumer laws.

- Purchase and Loan Participation Evaluation. Credit unions that purchase risk-based loans from other credit unions or participate in risk-based loans with credit unions involved should consider the cost of purchasing and servicing these loans as well as loan losses that may result from these loans.

  Performing a thorough due diligence review before committing to purchasing risk-based loans is crucial.

- Loan Procedures. Credit unions that offer risk-based lending programs should establish procedures that provide for diligent monitoring of loan performance and strong collection efforts, such as:

  - ◊ calling delinquent borrowers early and frequently;
  - ◊ investing in technology such as automatic dialing for follow-up telephone calls;
  - ◊ assigning more experienced collection personnel;

- ◊ moving quickly to foreclose or repossess collateral; and
- ◊ allowing few extensions.

Risk-based loan procedures should be in writing and at a minimum should elaborate:

- ◊ billing and statement procedures;
- ◊ collection procedures;
- ◊ content, format, and frequency of management reports;
- ◊ asset classification criteria;
- ◊ methods to evaluate the adequacy of the allowance for loan losses account;
- ◊ criteria for allowing loan extensions, deferrals, and re-agings;
- ◊ foreclosure and repossession policies and procedures; and
- ◊ loss recognition policies and procedures.

- Loan Review and Monitoring. Credit unions with risk-based lending programs should have information systems in place to analyze their loan portfolios (e.g., by originator, loan-to-value, debt-to-income ratios, and credit scores). Reports produced should enable management to evaluate the performance of the lending program and compare actual to expected results.

- Consumer Protection. Credit unions that originate or purchase risk-based loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Credit unions providing risk-based loans should institute compliance management programs that identify, monitor, and control consumer protection problems associated with risk-based lending. Following are some consumer regulations that apply to risk-based lending programs:

  - ◊ Truth-in-Lending
  - ◊ Regulation X, the Real Estate Settlement Act (RESPA)
  - ◊ Equal Credit Opportunity Act
  - ◊ Fair Housing Act

NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: **September 2004** **LETTER NO.: 04-CU-13**

TO: **Federally Insured Credit Unions**

SUBJ: **Specialized Lending Activities**

ENCL: **AIRES Questionnaires:**
(1) Sub-Prime Lending Controls
(2) Indirect Lending Controls
(3) Outsourced Lending Relationships

Dear Board of Directors:

The March 31, 2004 financial trends show that while the total volume of loans is increasing, shares are increasing at a faster rate causing the loan to share ratio to decline. As credit unions search for more lending opportunities, they may choose alternative lending arrangements.

As credit unions increasingly turn to alternative lending arrangements to meet their strategic objectives, safety and soundness concerns increase along with risks. As a result, NCUA has reviewed and updated the guidance provided to examiners to ensure it adequately explores pertinent issues and concerns.

This letter focuses on three higher risk lending activities – sub-prime lending, indirect lending, and outsourced lending relationships. Each of these lending activities can make good strategic business sense for credit unions when done with proper care. However, engaging in any of these lending activities exposes a credit union to a range of risks including credit, interest rate, liquidity, transaction, compliance, strategic, and reputation. It takes proper planning, experienced staff, and adequate controls and monitoring to make these profitable and productive activities for serving members.

Sub-prime Lending. Sub-prime lending is the practice of extending credit to borrowers who have weak credit histories (e.g., delinquent payments, charge-offs, judgments, bankruptcies), or reduced payment capacity (e.g., high debt ratios or low credit scores). A sub-prime portfolio will likely display significantly

higher delinquency and/or loss rates than prime portfolios. Typically, higher interest rates and fees are charged to sub-prime borrowers to compensate for the higher risk. Sub-prime portfolios generally require more intense and specialized collection efforts increasing a credit union's expenses in this area.

The term "sub-prime" is often misused to refer to certain "predatory" or "abusive" lending practices since a greater proportion of these practices occurs against sub-prime borrowers. Sub-prime lending that is appropriately underwritten, priced, and administered can serve to increase access to credit for borrowers with special credit needs and is not predatory by design. NCUA views as unsafe and unsound loans to borrowers who do not demonstrate the capacity to repay the loan as structured and where reliance for repayment is placed on the collateral pledged.

While sub-prime lending involves higher levels of risk and skill, properly managed, it can be a sound book of business. Sound underwriting practices, effective control and monitoring systems, and sufficient capital levels are key components to a well-managed program.

Indirect Lending. Indirect lending is an arrangement where a credit union contracts with a merchant to originate loans at the point of sale (e.g., an auto dealer). Generally, indirect lending is associated with auto loans. An indirect lending program can lead to rapid growth, changing the structure and risk profile of a credit union's balance sheet quickly. In addition to credit risk, on-going evaluation of both a credit union's liquidity and interest rate risk is essential.

A credit union should periodically review its approved dealers to ensure they meet certain standards including reputation, experience, and financial condition. Periodic review of approved dealers will ensure the dealer is not using excessive sales pressure on the borrower to increase its sales volume which could result in lower credit quality for the loans presented to the credit union. On-going review and monitoring of individual dealer loan statistics ensures the dealer's compliance with credit union credit criteria.

Written contracts should be in place addressing, at a minimum, dealer compensation, credit criteria, documentation standards, and dealer reserves. A dealer reserve account is controlled by the credit union and provides for charging back non-performing loans to the dealer under certain conditions.

Increased loan volume is a tangible benefit of indirect lending. Indirect lending can also provide a source of new members. However, a credit union needs to properly plan for and understand the risks of the program.

Outsourced Lending Relationships. Outsourced lending relationships can provide a credit union with greater flexibility in offering loans to members. Typically, a credit union will contract with a third party to originate or service

loans. NCUA Letter to Credit Unions No. 01-CU-20 addresses "Due Diligence Over Third Party Service Providers" and provides useful guidance for credit unions dealing with outsourced lending relationships. The letter highlights planning, background checks, legal review, financial review, return on investment, and controls such as policies and procedures, staff oversight, and reporting.

Outsourcing functions can be a profitable venture; however, a credit union must ensure proper controls and monitoring are in place.

Summary. When a credit union engages in any higher risk activity, it should be compatible with a credit union's risk tolerance, administrative capabilities, and strategic goals. The projected and realized impact on a credit union's financial performance should be analyzed regularly. Reasonable program limits should be established as well as on-going program monitoring and analysis.

Examiners will assess whether a credit union involved in specialized higher-risk lending activities has adequately planned for, and is monitoring and controlling those activities. Management will be adversely rated for failure to manage and control such programs.

To increase awareness and understanding of NCUA's approach to specialized lending programs, we are enclosing the revised examiner questionnaires used to evaluate programs. We encourage you to review these, compare them to your existing and/or planned activities, and then be in a position to effectively respond to and address questions that may arise.

Should you have any questions, please do not hesitate to contact your district examiner, regional office, or state supervisory authority.

Sincerely,

/S/

JoAnn M. Johnson
Chairman

Enclosures

NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: **October 2006** **LETTER NO.: 06-CU-16**

TO: **Federally Insured Credit Unions**

SUBJ: **Interagency Guidance on Nontraditional Mortgage Product Risk**

ENCL:
(1) Interagency Guidance on Nontraditional Mortgage Product Risk
(2) Interagency Credit Risk Management for Home Equity Lending Addendum
(3) Proposed Illustrations of Consumer Information on Nontraditional Mortgage Products

Dear Board of Directors:

The purpose of this Letter is to provide all Federally Insured Credit Unions with the final FFIEC *Interagency Guidance on Nontraditional Mortgage Product Risk* and the *Addendum* to the May 2005 *Interagency Credit Risk Management for Home Equity Lending* guidance. Both pieces of guidance were produced jointly by the Federal Financial Institutions Examination Council (FFIEC[1]).

The FFIEC developed this guidance to address risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. These products, referred to variously as "nontraditional," "alternative," or "exotic" mortgage loans (hereinafter referred to as nontraditional mortgage loans), include "interest-only" mortgages and "payment option" adjustable-rate mortgages. These products allow borrowers to exchange lower payments during an initial period for higher payments later.

The attached guidance discusses prudent underwriting and risk management practices for nontraditional mortgage loans, as well as the need to ensure consumer understanding of loan terms and underlying product risks. In addition to these documents, the FFIEC is issuing *Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products* for public comment in the Federal Register. The Agencies believe that illustrations of consumer

[1] The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision.

information may be useful to institutions as they seek to implement the consumer information recommendations of the Interagency Guidance. Credit Unions are encouraged to review and comment on the proposed illustrations which are also attached to this letter.

If you have any questions regarding the enclosed document, please contact your district examiner, regional office, or state supervisory authority.

Sincerely,

JoAnn M. Johnson
Chairman

Enclosures

Outsourced Lending Relationships

INTRODUCTION AND PURPOSE		
Background	**Yes/No**	**Comments**
1. Identify the third-party company(ies) or firm(s) with which the credit union outsources lending.		
2. Describe the scope of services provided by the third party.		
3. Does the credit union have reasonable rationale for outsourcing the services described above?		
Planning	**Yes/No**	**Comments**
1. Has the credit union performed a cost/benefit analysis to determine the need to outsource to a third party?		
2. Has the credit union evaluated the costs of monitoring, or providing support to, the third party (e.g., staffing, capital expenditures, communications, and technological investment)?		
3. Has the credit union considered the risks involved with outsourcing operations to a third party?		
4. Has the credit union determined a course of action should the third-party not be able to perform its responsibilities and does it have the ability to execute this course of action?		
5. Has the credit union performed a due diligence review and provided a formal written report to the board prior to executing an agreement with a third party, including:		
(a) Contacting references?		
(b) Evaluating the third party's expertise and operational capacity to meet its responsibilities?		
(c) Engaging legal counsel to review all contracts to understand each party's rights and responsibilities?		
(d) Evaluating the financial condition of the third party prior to any contract commitment and at least annually thereafter to determine that it will remain a going concern?		
(e) Reviewing financial audits conducted by independent parties?		
(f) Reviewing operational audits (including SAS 70 audits) conducted by independent third parties?		
(g) Reviewing the credit union's insurance requirements?		
(h) Contacting oversight agencies (e.g., Federal Trade Commission, Better Business Bureau, other regulators) to determine whether the business is in good standing?		

Outsourced Lending Relationships		
6. Does the credit union's internal or external audit scope provide for a comprehensive, independent review of any outsourced lending activities?		
Policies & Procedures	**Yes/No**	**Comments**
1. Do the credit union's policies (e.g., lending, collecting, ALM) appropriately address the outsourced relationship?		
2. Do policies place limits on loans originated or serviced by the third party based on:		
(a) Total loans outstanding?		
(b) Type of loan?		
(c) Collateral?		
(d) Credit quality?		
Monitoring	**Yes/No**	**Comments**
1. Are reports prepared on a monthly basis that adequately reflect the amount of activity with the third party and do reports provide sufficient information to properly monitor the activities?		
2. Are informative summary reports provided to senior management or the board of directors?		
3. Has the credit union assigned appropriate staff to oversee the outsourced relationship to determine compliance with responsibilities and contracts?		
4. If the third party originates loans, does the credit union verify the loan documents with the borrower?		
5. If the third party services/collects loans, does the credit union receive periodic reports on the loan portfolio?		
(a) Are reports received and reviewed timely?		
(b) Do they contain sufficient information to determine how the portfolio is performing?		
(c) Do report balances agree with the credit union's trial balances?		
(d) Do reports reflect quality collection efforts?		
6. Does the credit union control account verifications?		
7. Does the credit union verify that the outsourced party's reports are accurate?		
8. If the third party services loans, does the credit union verify that member payments are remitted to the credit union in compliance with the contract?		

Outsourced Lending Relationships		
9. Are funds received by the servicer required to be deposited in a trust account for the credit union's behalf? Alternatively, does the servicer use a third party "retail lockbox?"		
10. Are there reports received that show that returned or bounced payments are reversed, the loan re-aged, and any servicing fees are reversed?		
Legal	**Yes/No**	**Comments**
1. Does the credit union have a legal opinion on the contracts executed between the credit union and the third party?		
2. Is the credit union familiar with the rights, responsibilities, and obligations of both parties?		
3. Can the credit union terminate contracts for non-compliance or non-performance by the third party at a reasonable cost?		
4. Does the written contract:		
(a) Describe the duties, responsibilities, and specific performance standards of each party including the scope of the arrangement?		
(b) Specify that the third party comply with applicable laws and regulations?		
(c) Specify which party will provide consumer compliance-related disclosures?		
(d) Authorize the credit union to monitor the third party and periodically review and verify that the third party and its representatives are complying with its agreement with the credit union?		
(e) Require the third party to indemnify the credit union for potential liability resulting from action of the third party with regard to the lending program?		
(f) Address member complaints including any responsibility for the third party to respond to such complaints or forward them to the credit union?		
(g) Specify limitations on extensions, deferrals, renewals, or rewrites of loans, if applicable?		
(h) Specify which party physically holds original loan documents including, for example, applications, security agreements, and vehicle titles?		
(i) Require that the credit union be named as holding a perfected security interest in, for example, a vehicle held as collateral?		
Insurance	**Yes/No**	**Comments**

Outsourced Lending Relationships		
1. Did the credit union request evidence of current insurance coverage for third party employees?		
2. Does the third party purchase loss protection insurance (e.g., GAP insurance) or collateral protection insurance on behalf of the credit union as part of a servicing agreement?		
(a) Does the credit union review the financial strength and claims paying ability of the insurer?		
(b) Is the credit union named as beneficiary on the policy?		
(c) Will the credit union retain coverage in the event the arrangement with the third party is terminated?		

Cell: A4
Comment: Introduction and Purpose

Third party relationships provide credit unions with greater flexibility in offering loans to members. Typically, a credit union will contract with a third party to originate or service loans. These partnerships permit a credit union to implement loan programs more quickly than if the program was administered in-house, outsource experience or technology it does not possess, and enable the credit union to pilot a loan program so it can evaluate it prior to implementation.

However, outsourcing can also expose the credit union to risk, and result in unprofitable ventures if the credit union does not conduct proper oversight. The purpose of this guidance is to assist an examiner in determining whether the credit union is managing its third party lending relationship in a sound manner.

To fully evaluate an outsourced lending program, examiners are encouraged to complete this questionnaire in conjunction with any companion questionnaires focused on the underlying loan program, e.g. indirect lending.

Cell: A8
Comment: Background #3

The credit union should provide rationale for outsourcing the service. Reasons may include costs, inexperience, or lack of technology. However, as the following questions will indicate, outsourcing does not absolve the credit union from properly overseeing the duties performed by the third party.

Cell: A10
Comment: Planning #1

The credit union should thoroughly investigate the costs it would bear to internally perform the duties outsourced. This should be compared with the expected costs and fees incurred if outsourced. Because costs can change (e.g., dependent upon the volume of activity), the analysis should consider alternative scenarios.

In its analysis, the credit union should also consider the costs and benefits from an economic standpoint, not from an accounting standpoint. The credit union should look at the timing of actual cash flows, instead of how GAAP may permit a credit union to amortize costs or fees over time.

For example, a third-party may require fees to be paid up front for services to be performed in the future. If the credit union performed the service internally, it would pay for costs as they were incurred. By paying an up-front fee to the third party, an opportunity cost is borne by the credit union — it could have invested the funds to generate income, for example.

Also, fees may not be refundable leading to write-offs. For example, a company may charge $500 to originate and service a loan for a credit union. If the loan prepays rapidly, the credit union will have paid a $500 premium for little economic benefit.

Cell: A11
Comment: Planning #2

When evaluating the cost of outsourcing, the credit union should include costs that it will bear to meet its obligations or foster the relationship. This may include staffing costs associated with monitoring the third party's operations, costs that are passed on to the credit union because they are not covered under the base fee, investments in technology, and additional fees for optional services.

Preferably, the credit union will calculate its expected return on investment in terms of economic yield (e.g., bond equivalent yield [BEY]). Some credit unions may estimate returns on investment simply by estimating accounting income. This methodology is flawed for it generally does not account for the time value of money and is based on accounting cash flows (e.g., amortizing premiums/discounts over time) instead of actual cash flows.

For example, assume a credit union pays a firm $100 up front fee per originated loan. This fee reflects a premium paid for the loan. From an accounting standpoint, a credit union may amortize the premium over the life of the loan. Therefore, the "cost" of the premium is mitigated by time. From an economic standpoint, the upfront fee represents a cash outlay today and incurs an opportunity cost to the credit union. This reduces the total return on the originated loan.

Cell: A12
Comment: Planning #3
Risks include lack of total control over operations, lack of direct interaction with members, failure of the third party to meet expectations or contractual responsibilities, reputation risk (should the third party mistreat members), an inability to terminate a relationship that has soured, and liabilities incurred by the third party that may transfer to the credit union (for example, consumer compliance violations).

Cell: A13
Comment: Planning #4
This could lead to the credit union taking over responsibilities that it is not prepared or trained to do. For example, servicing sub-prime loans requires staff with special skills and experience which a credit union may not possess. Failure of the third party servicer could result in significant loan losses to the credit union.

The credit union should also consult legal counsel to determine what action it must take to settle such contractual issues as rescinding outstanding contracts, requiring performance from the third party, settling unpaid fees or obtaining refunds from amounts already paid.

Cell: A14
Comment: Planning #5
Letter to Credit Unions No. 01-CU-20, Due Diligence Over Third Party Service Providers, outlines several elements essential to evaluating a prospective partner.

Cell: A15
Comment: Planning #5(a)
The credit union should request a list of current references, and if possible, a list of clients that have terminated their relationship. The credit union should contact several of the listed references. This can assist the credit union in better understanding how the relationship will succeed, or what pitfalls it may encounter.

Cell: A16
Comment: Planning #5(b)
The credit union should interview several prospective firms to determine which is best qualified to meet its needs. Also, by interviewing several firms, the credit union may better understand the weaknesses of the candidates.

If the credit union is planning on establishing a relationship that will require a significant investment of resources and capital, it should consider hiring a consultant or industry expert to assist in its evaluation.

Cell: A17
Comment: Planning #5(c)
Legal review helps the credit union develop contracts that are fair to both parties. It is imperative the credit union understand what actions it may take in case the third party does not meet expectations or contractual responsibilities.

Cell: A18
Comment: Planning #5(d)

If the third party is a startup company, or is not financially strong, it raises questions whether it will remain in business over the term of the contract. Preferably, the credit union should only do business with well-established and financially-secure third parties.

If a less-established company is considered, the credit union should be certain the third party's failure will not significantly disrupt business. Appropriate contingency plans should be developed to address the potential failure of a third party performing outsourced services (e.g., discontinuing the service, performing the service in-house, or finding a new partner).

Deterioration in a third party's financial condition can lead to failure to perform, resulting in losses to the credit union. Regular monitoring of a third party's financial condition enables the credit union to identify emerging problems and to pursue other alternatives.

Cell: A19
Comment: Planning #5(e)
Audits provide the credit union with a level of assurance that the third party has fairly presented its financial condition. Based on audited financial statements, a credit union can determine the third party's financial stability and project it future ability to perform under the terms of the contract.

Cell: A20
Comment: Planning #5(f)
A SAS 70 audit refers to a situation where a third party performs only certain agreed upon procedures. For example, an auditor may be hired to determine that the controls implemented by a company are being followed. To understand its scope and limitations, an examiner should look to the engagement letter. Following the aforementioned example, the scope may not require the auditor to ascertain whether the company's system of controls is sufficient or to recommend additional controls.

These audits provide the credit union with another level of assurance that the third party can perform the duties expected of it.

Cell: A21
Comment: Planning #5(g)
Third party relationships can expose the credit union to additional liability that merits insurance coverage. The credit union should review its policies and coverage with the appropriate agents.

Cell: A22
Comment: Planning #5(h)
Agencies such as the FTC and Better Business Bureau may provide insightful information regarding complaints filed against the third party or improper practices.

Cell: A23
Comment: Planning #6
The credit union should determine that its internal or external audit reviews independently assesses the outsourced lending activity to ensure, among other things, the integrity of the records, particularly with respect to payment processing.

Cell: A25
Comment: Policies & Procedures #1
When outsourcing duties, the credit union must continue to maintain adequate controls over those functions. Policies should set forth limits and responsibilities that must be followed.

Cell: A26

Comment: Policies & Procedures #2
Policy limits shape the risk tolerance of the credit union. They also alert the third party to restrictions on certain types of programs. Otherwise, the third party may be inclined to engage in the business activity that generates it the most revenue.

Cell: A27
Comment: Policies & Procedures #2(a)
For new loan programs and/or new third party relationships, loan limits are especially prudent. They enable the credit union to evaluate performance prior to engaging in a significant volume of activity before all risks/costs/pitfalls are known.

Cell: A28
Comment: Policies & Procedures #2(b)
Limitations by loan type prevent unacceptable concentration risk. Concentrations can be by type of loan (secured, unsecured, type of collateral). Concentrations can also be by geographic area, by the credit quality of the loan (A, B, C, or D rated paper), by amount, etc.

Cell: A29
Comment: Policies & Procedures #2(c)
Limits ensure the credit union is not approving significant concentrations of collateral. For example, the credit union may prefer loans backed by new autos over those backed by used autos due to projected recoveries or loan performance.

Cell: A30
Comment: Policies & Procedures #2(d)
The credit union must monitor the quality of loans being originated to understand its credit risk exposure. Prudent limits control risk exposure.

Cell: A32
Comment: Monitoring #1
The credit union must monitor the performance of the third party relationship to determine compliance with expectations and contractual agreements. If deficiencies in performance are noted, a process to notify the third party of inadequate performance and to request corrective action should be implemented.

Cell: A33
Comment: Monitoring #2
Senior management and the board must be kept abreast of significant developments. The scope and content of reports should reflect the materiality of the program in relation to the credit union's earnings and net worth. Summary reports should provide enough information to be meaningful and from which management can make sound decisions.

Cell: A34
Comment: Monitoring #3
Failure to monitor the third party can lead to significant risk and losses. Further, the credit union may not recognize breaches of contract. Appropriate senior-level staff should be assigned to monitor compliance.

For example, if the third party servicer fails to repossess collateral in compliance with established timeframes, the credit union may incur a greater loss on sale or risk not being able to locate collateral.

Cell: A35
Comment: Monitoring #4
It is prudent for a credit union to verify, on at least a sample basis, loan documents, including the

application, note, and income/employment information. This is a control to verify the documentation is accurate, and the loan is genuine.

Cell: A36
Comm nt: Monitoring #5
The credit union should receive monthly reports detailing such information as the portfolio loan balance, credits and debits to borrower accounts, and delinquency status.

At a minimum, the content of reports should be of the same degree of detail that the credit union would expect if it was performing the function in-house. For example, the credit union may expect stratified delinquency reports by origination date, loan program and type, and collateral type.

Cell: A37
Comment: Monitoring #5(a)
Reports should be received no less frequently than monthly. Controls should be in place that require staff oversight.

Cell: A38
Comment: Monitoring #5(b)
The credit union should be able to assess the credit performance of the portfolio, including the aging of delinquency. Reports should also indicate the status of collection activity on each account and recent payment history. This information will help the credit union identify its potential losses and adequately fund the ALLL.

Cell: A39
Comment: Monitoring #5(c)
Balancing the servicer and credit union reports is a basic, but important control to ensure that all member payments are credited properly and all loans are accounted for.

Cell: A40
Comment: Monitoring #5(d)
Collection reports should be reviewed to determine that timely and appropriate actions are taken to protect the interests of the credit union. The credit union should ensure that promises of payment are followed up on and that consistent contact is made with the delinquent borrower.

Cell: A41
Comment: Monitoring #6
As an internal control, the credit union should control the issuance and receipt of all member account verifications. The servicer should be prohibited from this responsibility. Critical attention should be paid to confirmations returned for bad addresses, or accounts containing the servicers address.

Cell: A42
Comment: Monitoring #7
The credit union should sample the individual transactions or member accounts to verify accuracy. For example, the credit union may reconcile reports with payments actually received from the servicer, recalculate delinquency, and determine that payments are properly credited to borrowers' accounts. Errors should be brought to the attention of a supervisor, and if errors are material or chronic, then senior management and/or the board should be notified.

Cell: A43
Comment: Monitoring #8
It is imperative the credit union monitor the flow of member payments between the member, the servicer, and the credit union. Until payment is received by the credit union, the servicer is earning float, and more importantly, the credit union is exposed to credit risk—the risk that the servicer will fail or otherwise abscond with funds.

Cell: A44
Comment: Monitoring #9
The credit union must ensure member payments are not commingled with the servicer's funds. This prevents inaccurate record keeping and loss to the credit union should the servicer fail or be subject to litigation. As a control, the credit union should require payments collected by the servicer be deposited and accounted for in a separate account that is held for the benefit of the credit union.

A better method for receipt of payments is to have an agreement for a "retail lockbox." This method has the borrower send payments directly to the bank. The bank opens and records the payment and sends the records to the servicer and/or credit union. Independent third party control of funds is achieved.

Cell: A45
Comment: Monitoring #10
Payments that are returned or bounced must be reversed and the loan re-aged to before the payment was credited. Some servicers may assess servicing fees based on payments received. In this case, the credit union should ensure that the servicing fee is credited back to the credit union since a payment was not "technically" received.

Cell: A47
Comment: Legal #1
As with any third party relationship, the credit union must understand its rights, responsibilities, and liability under any executed agreement. Legal review can also assist the credit union in changing language that may be unfairly biased in the third party's favor. The legal review should be performed and documented by a party familiar with contract law prior to the credit union signing any contracts. Lack of a formal, documented legal review indicates a deficiency in the credit union's due diligence review.

Cell: A48
Comment: Legal #2
Management should be aware of each party's contractual obligations (e.g., days between approval of loan by third party and receipt of loan documentation in house), and how management may terminate the contract if the performance expectations or contract obligations are not met. Unfamiliarity with such concepts, may indicate the credit union is not monitoring the program.

Cell: A49
Comment: Legal #3
Determine how costly termination of the contract may be to the credit union. If poorly structured, the credit union may not be able to terminate the contract without significant cost, or in a timely manner.

Long-term servicing commitments by the third party may be a source of loss to the credit union if a contract does not allow for exit. Despite non-performance, the credit union may need to continue paying servicing fees if no exit clause exists.

Cell: A50
Comment: Legal #4
The credit union should have a written contract with the third party that describes, in detail, the specific duties, responsibilities, and performance standards of each party. It should be reviewed by legal counsel to ensure the credit union's interest are adequately protected and it should be periodically reviewed, especially in light of changing business conditions. The following list is not all-inclusive, however, the credit union should, at a minimum, determine the appropriateness of each item.

Cell: A56
Comment: Legal #4(f)
If the credit union is not responsible for handling the complaints, it should receive copies of member complaints along with the service provider's response.

Cell: A58
Comment: Legal #4(h)
Generally, the credit union should hold the original loan documents. If the credit union does not hold the original documents, the servicing agreement should specify that they are held in trust by an independent party (separate from the servicer).

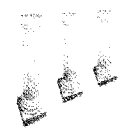
Cell: A59
Comment: Legal #4(i)
The contract should specify that the credit union is named as lien holder on a title to a vehicle and not the servicer, for example. This further protects the credit union's interests in the collateral securing a loan in the event the borrower defaults.

Cell: A61
Comment: Insurance #1
Insurance coverage, including fidelity and errors and omission coverage, should be carried by third parties providing services to a credit union. It should also cover subcontractors, if applicable. Coverage amounts should be sufficient to mitigate risk associated with the loan services provided by the third party. The credit union should establish a process to confirm the continued maintenance of insurance coverage on a regular basis.

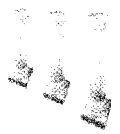
Cell: A62
Comment: Insurance #2
When loss or collateral protection insurance is purchased by a third party as part of a servicing agreement, the credit union should obtain legal counsel's review to ensure the coverage will be maintained and the credit union will receive future insurance payments if the servicing arrangement with the third party is terminated. In addition to the maintenance and payment of collateral protection insurance, the credit union should be certain that collateral protection insurance payments are amortized in accordance with applicable state laws and loan contracts.

The credit union should also review the financial standing and claims paying ability of the insurer. Failure of the insurer could render the policies worthless.

Cell: A63
Comment: Insurance #2(a)
The claims paying ability of insurance companies is rated by third party organizations. This rating should be reviewed as part of the financial strength of the company.



Supervisory Letter



Increasing Risks in Mortgage Lending

Introduction

The mortgage lending market has changed dramatically during recent years to accommodate the financing needs of consumers. According to Douglas Duncan, chief economist of the Mortgage Bankers Association[1], there are over 200 kinds of mortgage products on the market. All of these products have different terms, interest rates, down payment requirements, etc. The newer product choices offered to consumers bring with them different risks than traditional mortgage loans, both to the consumer and to the credit unions who make these types of loans.

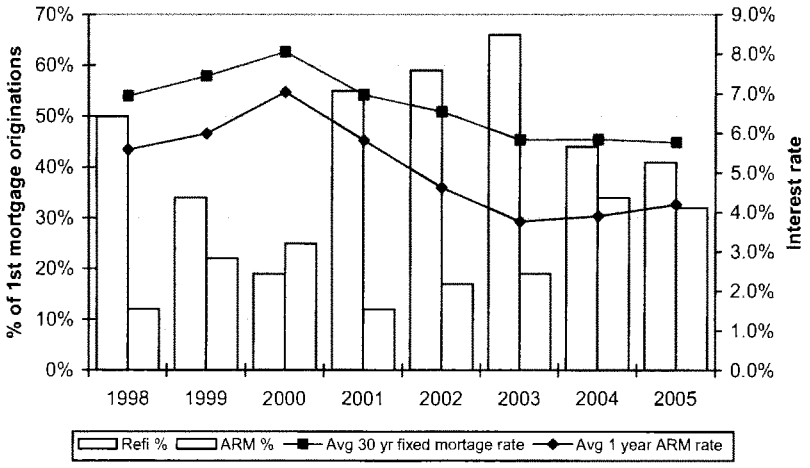
Background

In 2003, interest rates declined to 45-year lows, resulting in a refinancing boom where borrowers locked in low-rate long-term mortgages. In that year NCUA issued Letter to Credit Unions Number 03-CU-15, entitled "Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed Rate Mortgage Portfolios." The concern at that time was interest rate risk related to the increasing concentration of fixed rate real estate loans when rates were at levels not seen in 45 years.

As interest rates were declining from 2000 to 2003, the majority of loans originated were refinances, with adjustable rate loans comprising less than 20 percent of all loans granted. As rates for fixed-rate mortgages leveled off, the percent of refinancing declined. Purchase money loans again comprised the majority of loans granted, and the level of adjustable rate mortgages comprised a growing share of those loans. These trends are seen in the graph below.

[1] As quoted in "Greenspan Wary of Risky Mortgages: Price Peaks Built on 'Exotic' Loans Trouble Fed Chairman" by Nell Henderson and Kirstin Downy, Washington Post, June 10, 2005.

Interest Rate and Composition of Originations



Source: MBAA & Freddie Mac

During this period of low rates many areas around the country, especially along the east and west coast, were experiencing significant levels of price appreciation in the housing market. According to the National Association of Realtors, the median sales price of existing homes in the U.S. increased by 8.5% in 2003, 9.3% in 2004, and 14.7% for the twelve months ending June 30, 2005. In several areas, the rate of increase is much higher; for instance, home prices in California, Rhode Island, and Washington D.C., have doubled in five years.[2]

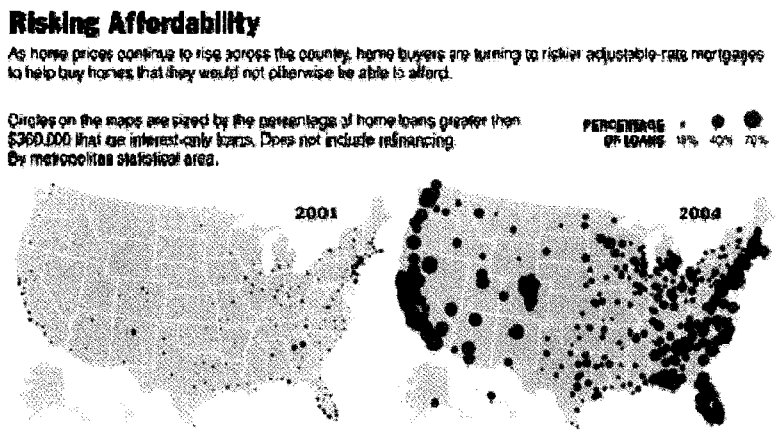
These increases resulted in the cost of housing becoming less affordable even while interest rates remained near historically low levels. To counter this and to stimulate mortgage volume, lenders have become more innovative in the products they offer and more aggressive in their marketing. The current demand for conventional ARMs, Interest Only (IOs) ARMs, Hybrid ARMs, Payment Option ARMs, as well as the use of piggyback lending defies the historical correlation between interest rates and the popularity of these products.

> *"The dramatic increase in the prevalence of interest-only loans, as well as the introduction of other relatively exotic forms of adjustable-rate mortgages are developments of particular concern."*
>
> *- Federal Reserve Chairman Alan Greenspan*

[2] Freddie Mac – Home Price Index by State – June 2005

Typically, ARMs become popular when interest rates rise because borrowers use the lower ARM rate to reduce costs with the expectation that rates will decline. In times of low rates, borrowers typically lock in the rates with fixed-rate, long-term mortgages. However, the opposite has occurred with ARMs becoming more popular in this low rate environment given the extraordinary appreciation in housing prices. Borrowers, particularly in areas with high rates of real estate appreciation, are opting for ARMs and other exotic products which allow them to afford higher priced homes due to the lower monthly payments at origination. During the second half of 2004, adjustable-rate and IO loans accounted for 63% of mortgage originations [3] and in recent months, Option ARMs and IO loans accounted for 65% to 75% of all jumbo-mortgage originations.[4]

LoanPerformance, a unit of First American Corp., reports nearly 25% of all mortgage loans this year have been IOs, and that in the first two months of 2005 nearly 61% of California purchase mortgages were IOs, up from 47% in 2004 and less than 2% in 2002.[5] The level of IO loans in California is much higher than the nationwide level of 31%. The graphic below illustrates concentrations of IO loans across the nation.



Source: LoanPerformance

Examiners should be aware that the transition in mortgage products reflects a liberalization of mortgage credit standards in general. Consequently, examiners should be alert to changes in underwriting procedures, written or practiced, indicating an increased appetite for credit risk at the credit unions they review.

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[3] According to the Mortgage Bankers Association as quoted in "Beware The Interest-Only Mortgage" by Liz Moyer, Forbes.com, June 6, 2005

[4] According to UBS AG as quoted in "Housing Gets Even Less Affordable" by Ruth Simon, Wall Street Journal, July 14, 2005

[5] According to LoanPerformance as quoted in "Concerns Mount About Mortgage Risks" by Ruth Simon, Wall Street Journal, May 17, 2005

What is the risk and why is it increasing?

The newer mortgage loan products carry higher levels of credit risk than the standard 80 percent loan to value, 30 year fixed-rate mortgage. This risk is due in part to the structure of the loan products combined with changes to underwriting standards and the high levels of home price appreciation. Price appreciation was discussed earlier, so this section will focus on the credit risk in the loan products and the changes to underwriting standards.[6]

New Mortgage Loan Products

A comparison of the features and issues is important to determine the risks of the various mortgage products, as follows:

Product	Features	Issues
Payment Option ARMs	Minimum payment is not a set amount each month. The borrower has the choice of up to four payment options: 1. **Minimum payment** – based on the "initial rate" which can be as low as 1%. Negative amortization is added to the loan balance. 2. **Interest only payment** – all interest due, no principal 3. **30-year amortizing payment** 4. **15 year amortizing payment**	• Borrower qualifies at initial, IO payment. • High potential for payment shock. The options are complicated and borrowers may concentrate on initial low minimum payments. • Minimum payment selection will cause negative amortization. • Every 5 years (or 115% negative amortization) the loan is recast to ensure minimum payments pay off the balance by the end of the loan's term.
Interest Only	Borrower pays only interest for a fixed period – typically 3, 5 or 10 years. Principal is then amortized over the remaining term. These can be similar to a Hybrid ARM, with a fixed rate, interest only initial period, converting to a variable rate, amortizing period.	• Borrower qualifies at initial, IO payment. • Allows borrower to purchase a higher-priced home than they could otherwise afford. • Will eventually require principal payments at an accelerated pace, with significant increases to monthly payments. • Borrower could owe more than the value of the home if housing value declines during IO period.

[6] While not discussed in this letter, there is transaction risk associated with these loans. Credit unions should have the ability to process and account for these complex loans before offering them.

Product	Features	Issues
Conventional ARM	Rates adjust periodically, typically tied to a published index. The frequency of adjustments and the index vary. Caps typically limit the change during any one year and over the life of the loan.	• Borrower is self-insuring against rate increases during the time they hold the loan. • If the increase in ARMs is due to affordability, there is likely a brewing problem. • Delinquencies and losses are higher for ARMs than for fixed-rate mortgages.
Hybrid ARM	For instance 3/1 and 5/1 – the first number is the length of the fixed term and the second is the adjustment interval applied after the fixed period ends. Annual and lifetime change caps also apply to these loans.	• Bridges gap between fixed and adjustable rate mortgages. • Rates are typically lower than conventional fixed, but higher than ARMS due to the fixed-rate period. • Also come with an interest only option, typically lasting for the fixed rate period.
Fixed-rate conventional	Rate is fixed at inception with principal amortizing over term of loan, typically 15, 20, or 30 years.	• Higher rate is "insurance" a borrower pays to protect against increasing interest rates. • Most recent "innovation" is a 40-year mortgage. • Risk to borrower is they seldom stay in the home for the full term, so are paying for insurance they won't likely need.

The IO mortgage has been around since the 1920s when it was primarily used for the wealthy to manage their cash. If an average person was to get a mortgage at that time to purchase a property, the primary loan available had a term of 5 years, had a fixed rate of interest, a balloon payment at the end of the loan term, and required a 50-80% down payment. The primary underwriter for these loans was insurance companies, not banks. They made these loans not for the interest income, but in hope of the borrower defaulting so they would take ownership of the property.

These fell out of favor during and after the great depression when real estate and stock prices plummeted, and only became a mainstream loan type in the last 2-3 years. Unlike the IO loans of the past, the current offerings do not have a balloon feature, are not fixed rate, and are not limited to the wealthy. Some of these loans greatly increase credit risk by allowing negative amortization and all of them have no initial principal repayment.

Many borrowers choose these loans counting on the continued increase in the value of their home. However, when combined with a potentially overpriced real estate market, the impact of this credit risk increases tremendously. When the principal repayment becomes a reality, the minimum payment on these loans can increase significantly and may not be manageable by the borrower. Additionally, if prices stay flat or decline, the borrower could owe more than the property is worth. The likelihood of default is much higher when a borrower has no equity in the home.

The tables below show the increase in the minimum payment for two types of adjustable rate, IO mortgages. In the first example, a $200,000 mortgage has an interest only feature for three years, after which it is adjusted annually with a 2% initial adjustment and 2% annual, 6% lifetime caps. As shown below, changes in interest rate can dramatically change a borrower's mortgage payment. Even with no rate changes, the payment can increase as much as 33% once the interest only period ends. Combine that with a rise in interest rates and the payment can increase 63% at the initial adjustment period, and up to 126% after all adjustments.

$200,000 3/1 IO ARM – 2/2/6 caps									
	No change in rates				Maximum change in rates				
Year	Int. Rate	Pmt	Change	% chg	Int. Rate	Pmt	Change	% chg	Cum. chg
1-3	5.15%	$858.33			5.15%	$858.33			
4	5.15%	$1,143.98	$285.64	**33%**	7.15%	$1,395.25	$536.91	**63%**	**63%**
5	5.15%	$1,143.98			9.15%	$1,661.03	$265.78	**19%**	**94%**
6	5.15%	$1,143.98			11.15%	$1,937.63	$276.65	**17%**	**126%**

Source: FNMA Calculations

The increase in payment is even more dramatic under the second scenario using a $200,000 mortgage with interest only payments for five years. After five years the rate is adjusted annually with a 5% initial maximum adjustment and 2% annual, 5% lifetime caps. With the interest rate rising 5% at the initial adjustment period, the payment increases 104%.

$200,000 5/1 IO ARM – 5/2/5 caps								
	No change in rates				Maximum change in rates			
Year	Int. Rate	Pmt	Change	% chg	Int. Rate	Pmt	Change	% chg
1-5	5.60%	$933.33			5.60%	$933.33		
6	5.60%	$1,240.15	$306.81	**33%**	10.60%	$1,902.67	$969.33	**104%**

Source: FNMA Calculations

These examples clearly illustrate the huge potential for borrowers to become overburdened by changes in their mortgage payments that may result as rates rise and/or the interest only options expire. Teaser rates, or initial low rates, are

often used to attract borrowers to ARM products; however, the teaser rate can expire within six months, and sometimes in as little as one month. These introductory rates also pose credit risk because payments may significantly increase at the end of the teaser rate term.

A piggyback loan is defined as a simultaneous first and second mortgage designed to enable borrowers to receive a large loan with up to zero down payment.[7] Piggyback loans have become more attractive due to the record home price appreciation in many markets.

> *"The House Price Index shows the rise in house prices continues at an extremely strong pace and raises the potential for declines in some areas later on."*
>
> *-- OFHEO Chief Economist Patrick Lawler*

According to a June 2005 report by Calhoun Consulting, during the first half of 2004 approximately 42 percent of home purchase mortgage loan dollars involved piggyback loans.[8] This percentage doubled from 2001. These loans (along with IO mortgages) tend to be concentrated in areas with rapidly increasing housing costs which have far outpaced income growth. This type of lending allows borrowers to afford a more expensive home with a lower down payment and no private mortgage insurance premiums. Further, the interest payments on the second lien portion of the loan are tax deductible.

These loans are attractive to lenders because fee income is increased by originating two loans instead of one, and the first lien conforms to secondary market standards for selling purposes. The drawback is that many borrowers are not prepared for increased payments as interest rates rise since the second trust is typically a variable-rate home equity loan. Also, areas with the highest real estate appreciation are often at the highest risk of experiencing declining house prices. Piggyback loans may support the speculative bubbles in local housing markets by qualifying borrowers for larger loans with higher loan to values. As long as housing values rise at the current pace this arrangement will work; however, these loans may result in high loss rates if housing values decline.

FNMA published an informative paper that discusses adjustable rate mortgages in detail. "The Pluses and Minuses of Adjustable-Rate Mortgages" can be viewed at: http://www.fanniemae.com/commentary/pdf/fmpv3i4.pdf

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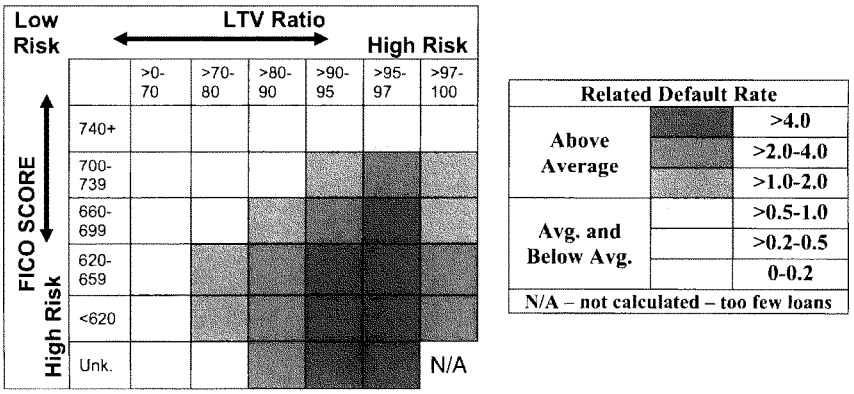
[7] Also see Letter to Credit Unions 05-CU-07 – "Risks Associated with Home Equity Lending"
[8] SMR Research Corporation, "Piggyback Mortgage Lending, November 2004, as quoted in "The Hidden Risks of Piggyback Lending" by Charles A. Calhoun, PhD, June 2005 http://www.pmigroup.com/newsroom/media_newsroom/hiddenriskspiggyback.pdf

Liberalized Underwriting Standards

To remain competitive and increase volume, many lenders appear to be loosening their credit standards. Some of the current practices include:

- Being more creative in structuring loans so borrowers can qualify for loans that they previously would not be approved for given their income levels. It is not unusual for up to 50% of income to be allocated for a mortgage payment when in the past this was limited to between 28% and 32%.[9]
- Qualifying borrowers at the interest only payment level or initial rate rather than at the subsequent or highest possible payment. This practice is an approved secondary market underwriting standard.
- Making additional loans resulting in higher total LTVs while avoiding private mortgage insurance (piggyback).
- Reducing loan documentation. According to Inside Mortgage Finance, almost 7% of new loans in 2004 were low-documentation loans, up from 2% in 2003.[10]

The trend towards liberalizing underwriting standards further increases credit risk. The effects of relaxed standards cannot be fully measured currently because these changes are too recent. However, as evidenced in the chart below, a correlation exists between LTV ratios and credit scores. When a lower level of equity is required from the borrower and this is combined with lower credit scores, default rates rise.



[9] "Analysts see solid growth for builders: Housing demand stays strong; loan standards a concern", by John Spence, MarketWatch, July 8, 2005.
[10] "Getting in at any price: What risk do new loan products pose for housing market" by Andrea Coombes, MarketWatch, May 6, 2005.

The chart was taken from the February 2005 GAO report on mortgage financing and analyzes the results of the 4-year default history of 1997-1999 originations. GAO concluded that conventional mortgages with higher LTVs and lower credit scores have higher default rates. Given this conclusion, if we combine more lenient credit and underwriting standards with higher LTVs, IO or negative amortization loans, and with the rapid appreciation in housing values, it is possible we could see default rates increase over current levels.

> *"It is important that lenders fully appreciate the risk that some households may have trouble meeting monthly payments as interest rates and the macroeconomic climate change."*
>
> *Federal Reserve Chairman Alan Greenspan*

Conclusion

Mortgage lending has changed in recent years. Products and processes that were once standard operating procedure have been revised radically in almost every aspect of the business. Piggyback loans, IOs, and other new mortgage products have become very popular, primarily in areas with high levels of real estate appreciation. When coupled with more liberalized lending practices that only consider the initial payment on interest only products, the heightened level of risk becomes clear.

In areas with high price appreciation borrowers are opting for these newer products so they can qualify for more expensive homes than they would under conventional mortgage terms. In the end, these products replace interest rate risk with credit risk as many borrowers may not be able to afford a higher mortgage payment when interest rates rise, potentially increasing default rates. A drop in real estate property values coupled with the unanticipated burden of increased payments as interest rates rise will likely result in hardship for borrowers and could cause default rates to increase.

When reviewing a credit union's real estate loan programs, examiners should:

- Analyze the mortgage loan products offered by the credit union, carefully evaluating any associated risks, especially in markets with large housing price appreciation.
- Evaluate the level of exposure a credit union is placing on its balance sheet and whether or not the risk is being mitigated (e.g. through selling the more exotic products).
- Assess changes in mortgage underwriting credit standards as reflected in credit union policies and practices.

- Discuss these risks with credit union officials to ensure they are aware of the inherent risks and have the appropriate policies, procedures, and monitoring mechanisms in place to manage the risks while ensuring these products fit into their overall strategic plan.
- Determine that the credit union maintains sufficient capital to support the level of credit risk and interest rate risk.

Our objective is to ensure that credit unions have in place appropriate risk management practices to mitigate the exposure posed by the changing risks in mortgage lending and the related economic environment. Examiners who find credit unions engaged in material levels of the activities described in this letter, or other practices that indicate loosened mortgage credit standards, need to ensure that these programs are safe and well-managed. Any significant deficiencies in a credit union's management of the risks associated with mortgage lending should trigger heightened supervisory oversight.

For Release Upon Delivery
10:00 a.m., March 27, 2007

TESTIMONY OF

EMORY W. RUSHTON

SENIOR DEPUTY COMPTROLLER

AND CHIEF NATIONAL BANK EXAMINER

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

SUBCOMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

March 27, 2007

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

INTRODUCTION

Chair Maloney, Ranking Member Gillmor, and members of the Subcommittee, my name is Wayne Rushton, Senior Deputy Comptroller and Chief National Bank Examiner for the Office of the Comptroller of the Currency (OCC). I welcome this opportunity to appear before you today to discuss developments in mortgage underwriting and marketing practices, particularly in the subprime market, that have been the focus of attention by the OCC and the other federal banking agencies. Before discussing subprime mortgage lending and the OCC's supervision of national banks, I think it is important at the outset to make the following observations:

First, it is clear that some subprime lenders have engaged in abusive practices – including making loans that borrowers cannot realistically repay -- and we share the Subcommittee's strong concerns about them. But, it would be wrong to equate all subprime lending with predatory lending. Subprime loans have helped to provide mortgage financing for millions of first-time homebuyers with few credit options, and this segment of the population is important to the economy. No one wants to see creditworthy consumers shut out of the credit markets, and so we need to work together to ensure that they are treated fairly and responsibly without cutting off their access to credit.

Second, the vast majority of subprime loans are not originated in the national banking system or supervised by the OCC. While some national banks and their subsidiaries help to serve the credit needs of the subprime market, their subprime lending last year amounted to less than 10% of the total of subprime mortgage originations by all lenders. Subprime lending is a specialized business that must be carefully managed to maintain safety and soundness, to mitigate risks, and to ensure fair treatment of borrowers. National banks and their subsidiaries

that engage in subprime lending are subject to extensive oversight by OCC examiners and must operate in close compliance with the OCC's rigorous safety and soundness and consumer protection standards. Unsound underwriting standards and abusive lending practices have no place in the national banking system. Some have said, perhaps not surprisingly, that there is a direct connection between the rigor of the OCC's supervision of subprime mortgage lending and the low level of this activity in national banks. Indeed, there have been recent instances in which banks have decided against converting to a national charter for this very reason.

Third, we are now confronting adverse conditions in the subprime mortgage market, including disturbing but not unpredictable increases in the rates of mortgage delinquencies and foreclosures. These conditions can be attributed to a variety of factors, including changes in local economies that affect borrowers' creditworthiness and home values; the willingness of investors -- and borrowers -- to assume greater levels of risk; fraud in the application process; intense competition; and a relaxation of lending standards. With regard to matters that are within the purview of the bank regulatory agencies, let me assure you that we will work together, in the institutions we supervise, to obtain appropriate corrections to underwriting practices that cause us concern. Given the importance of the housing sector to our economy and to our national policy goals, however, it is imperative that we all use the right degree of pressure when "applying the brakes" to avoid putting in jeopardy the segments of the market that are working well and that have helped to raise homeownership rates to historic levels.

Finally, as we seek to address the concerns that have been raised about subprime mortgage lending, we need to recognize the predominant role played by nonbank companies in providing financing to subprime borrowers. Almost half of all subprime loans originated in 2006 were made by nonbank lenders, and this is due to several factors. First, insured

depository institutions, whether nationally- or state-chartered, are the most heavily regulated of all financial institutions, and they also tend to have the most conservative underwriting standards. This may account for the fact that banks have the smallest share of the subprime market. Nonbank affiliates of bank and thrift holding companies have a larger share of subprime originations than do banks. However, as noted above, state-regulated nonbank lenders and brokers that originate these loans have captured the largest share of the subprime market recently -- primarily because hedge funds and private equity investors provided extraordinary liquidity to fuel this growth by purchasing loans originated by nonbanks, as well as securities backed by these loans, in the secondary market. Given the complexity of subprime mortgage finance, and the variety of companies engaged in the activity, adopting and implementing consistent standards across *all* segments of the mortgage lending industry is crucial to promoting sound loan underwriting and to helping consumers understand the material terms and risks of these loan products.

My testimony today will describe these developments in the mortgage market, as well as recent interagency guidelines on mortgage lending. I will also discuss the OCC's supervisory process to describe how we seek to prevent national banks and their subsidiaries from engaging in unfair and deceptive, predatory, or unsafe and unsound mortgage lending practices. In this regard, I will describe supervisory and regulatory standards that the OCC has issued relating to mortgage lending by national banks and their mortgage lending subsidiaries, how we examine these institutions for compliance with these standards, and relevant enforcement actions.

Developments in the Subprime Mortgage Market

Throughout most of the 1990s, mortgage origination volumes remained steady at around $1 trillion per year. Beginning in 2001, however, interest rate reductions by the Federal Reserve Board had a substantial impact on the mortgage market. As interest rates declined, many borrowers refinanced existing loans, often lowering their interest rates and extracting cash at the same time. The result was a three-year rapid expansion of the mortgage market that peaked in 2003 with just under $4 trillion in new originations. When the Federal Reserve began raising interest rates in 2004, the impact on mortgage markets was almost immediate. By the end of 2004, originations volume declined to just under $3 trillion, a 26% drop from 2003.

As one might expect, the 2001-2003 surge in demand prompted mortgage lenders to expand their operations to boost capacity. These conditions also attracted new market participants, often lenders with little business experience or financial strength. When loan demand slowed in 2004, the market was left with overcapacity. To maintain production levels, and satisfy continued strong investor appetite, mortgage originators shifted to "innovative" products, often designed to help borrowers cope with rising home prices or continue to tap idle home equity. Some of these "innovations" included relaxed underwriting standards and temporary payment reductions that increased risk for both borrowers and lenders.

In recent years, 15- and 30-year fully amortizing conventional loan products have declined from 62% of total originations in 2003, to just 33% by the end of 2006, while originations of loans to subprime borrowers, and originations of interest only (IO) and payment

option adjustable-rate mortgage (ARM) loans to prime or near-prime borrowers, have increased. For example, loans to subprime borrowers increased from just 8% of total originations in 2003, to 20% in 2005. Subprime originations peaked in 2005 at a total of $625 billion in originations, and declined to about $600 billion in 2006, with a 20% market share in both years. Originations of loans to the so-called Alt-A market, including nontraditional products such as IOs and payment option ARMs, grew from only 2% in 2003 to 13% by the end of 2006.

In contrast to their share of the mortgage market generally, and their share of commercial banking assets, national banks have not been significant players in the subprime loan market. Roughly two-thirds of commercial bank assets are held by national banks. In addition, almost one-third of the approximately $3 trillion in total mortgages that were originated in 2006 were originated by national banks or their subsidiaries. However, as I noted earlier, subprime lending by national banks and their subsidiaries in 2006 amounted to less than 10% of the total $600 billion in subprime mortgage originations by all lenders.

In response to the question posed in your letter, subprime loans originated by national banks have been performing better than subprime loans in the general market. Moreover, given this performance, as well as the very limited holdings of subprime loans by national banks noted above, the current problems affecting the subprime market do not threaten the viability of any national bank.

However, loan performance in the subprime sector generally, as we have been seeing, is deteriorating. Recent statistics reported in a nationwide survey by the Mortgage Bankers Association (MBA) showed that 14.44% of subprime borrowers with ARM loans were at least

60 days delinquent in their payments in the fourth quarter of 2006.[1] This was an increase of 122 basis points from the third quarter delinquency rate for such mortgages of 13.22%. According to the MBA survey, foreclosure start rates for subprime loans increased 18 basis points (from 1.82% to 2%) during the fourth quarter of 2006.

The OCC has carefully monitored these changes in the mortgage market over time, with particular focus on developments affecting the national banking system, and taken preventive steps as appropriate to address safety and soundness and consumer protection concerns as they have been identified. The OCC has addressed the liberalization of mortgage underwriting and the need for caution in four consecutive Annual Surveys of Credit Underwriting Practices, beginning in 2003. In 2004, we began to take particular steps to assess the risks associated with this activity. These steps included a survey of national bank originations of IO and payment option ARM loans, including underwriting and marketing practices. Based on our preliminary findings, in 2005, we initiated an interagency process to develop guidelines to address emerging risks affecting both safety and soundness and consumer protection. This process culminated in the special guidance on nontraditional mortgages, described below, that was issued in 2006.

Close in time to the interagency work on nontraditional mortgage guidance was our review of subprime mortgage loans, including the so-called "2/28" and "3/27" hybrid ARM products. We determined that these loan products, although not technically covered by the nontraditional mortgage guidance, raised underwriting and consumer protection concerns that are similar in several respects to those raised by IO and payment option ARM products. In particular, the agencies, as well as members of Congress and the public, became concerned that

[1] National Delinquency Survey, Mortgage Bankers Association, March 2007.

lenders are not appropriately underwriting these loans and have loosened their borrower qualification standards too far in response to increasing competition for loan volume. For example, with respect to more recent vintages of subprime hybrid ARMs, the agencies are particularly concerned about the potential for increased levels of delinquencies and potential defaults and foreclosures after the payments reset.[2] Based on our assessment of these trends, we developed the proposed interagency statement on subprime lending, which also is described below.

OCC Supervisory Guidance Relating to Mortgage Lending

In addition to on-site examinations and extensive public outreach, an important component of the OCC's oversight of national banks is our provision of written supervisory guidance. We use the guidance process to alert national banks to practices that may raise legal, compliance, safety and soundness, and consumer protection risks and concerns, and to try to prevent such risks from taking hold in the national banking system. Our examiners then apply the principles articulated in guidance in their ongoing bank supervision activities. Over the past several years, the OCC has issued supervisory guidance to national banks on a wide range of matters involving potentially abusive, unsafe and unsound lending practices, providing both general guidelines and more targeted directives where appropriate.[3]

[2] According to a Special Report by Moody's (March 3, 2007), serious delinquencies increased dramatically for subprime loans originated in 2006, in contrast to delinquency patterns for subprime loans originated in the years 2002 to 2005.
[3] *See* Attachment A.

Guidance on Nontraditional Mortgages

In October 2006, the OCC and other federal banking agencies (the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration) issued final guidelines addressing a variety of supervisory issues raised by nontraditional mortgages (NTM guidance), such as IO mortgages and payment option ARMs.[4] Nontraditional mortgage products have frequently been marketed as "affordability" products, and they have been structured to reduce monthly payments in the early years of the loan to make the loan more attractive to borrowers. The agencies were concerned that underwriting standards had eroded to the point that some lenders were paying too little attention to the borrower's ability to make the higher payments that would be required later in the loan term. The agencies also were concerned that such "back-loaded" repayment structures may cause borrowers to commit to substantial increases in required monthly payments that they may not understand or be able to afford. This potential for payment shock, which can be severe given the non- or partially-amortizing nature of these products, is the most significant consumer protection concern related to nontraditional mortgage products.

The NTM guidance directs financial institutions to address and mitigate the risks inherent in nontraditional mortgage products. This includes ensuring that loan terms and underwriting standards are consistent with prudent lending practices, which require a credible analysis of a borrower's repayment capacity. In this regard, the NTM guidance provides that

[4] 71 Fed. Reg. 58,609 (October 4, 2006). We published proposed guidance addressing these concerns in December 2005, and asked for public comment on the proposal. After evaluating the public comment we received on the proposal following the end of the 90-day comment period, the agencies issued the final NTM guidance in October 2006. Most lenders strongly objected to what were deemed to be "overly prescriptive" borrower qualification and consumer protection standards in the proposed guidance. However, the agencies adopted this guidance, essentially as proposed, including the strong borrower qualification and consumer protection standards, in order to address the concerns we had about these practices.

such loans should be underwritten based on a borrower's ability to make fully-amortizing payments at the fully-indexed interest rate. For products like payment option ARMs that permit negative amortization, the guidance provides that a lender's underwriting analysis should be based on the initial loan amount plus any balance increase that may accrue over time based on the maximum potential amount of negative amortization that the loan permits.

The NTM guidance also addresses the increasingly common practice of institutions to rely on reduced documentation, particularly unverified income, when they qualify borrowers for nontraditional mortgage loans. This practice essentially substitutes assumptions and alternative information for verified data in analyzing a borrower's repayment capacity and general creditworthiness. Because this practice can present significant risks, including the risk of fraud, it should be used with caution. Accordingly, the NTM guidance provides that the use of reduced documentation, such as unverified, stated income, should be accepted only if there are other mitigating factors that minimize the need for direct verification of repayment capacity. Further, the NTM guidance notes that institutions generally should be able to readily document income for many borrowers using recent W-2 statements, pay stubs, or tax returns.

Finally, the NTM guidance addresses the need for financial institutions to provide timely, clear, and balanced consumer information about nontraditional mortgage products, including information about the potential adverse consequences of these loans, such as payment shock and negative amortization. This information should be provided to consumers when they are shopping for a loan. In addition, the guidance provides that information that will allow consumers to make informed choices concerning payment options should be provided with any monthly statement on a payment option ARM.

The NTM guidance took effect immediately upon its publication on October 4, 2006, and it applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. We are now in the process of ensuring that national banks that offer nontraditional mortgage products perform a self-assessment to determine whether their operations comply with the guidance and, if not, to bring their operations into conformity. And, of course, we will confirm this information, and monitor compliance, through our on-site examination process.

At the same time the agencies issued guidance on nontraditional mortgage product risks, we published for comment proposed illustrations of the consumer information contemplated in the guidance. Commenters, including community banks, generally favored the issuance of these illustrations as a simple "compliance aid" in implementing the disclosure recommendations contained in the NTM guidelines. The agencies have carefully considered the comments we received and we expect to be able to finalize the illustrations in the next several weeks.

Proposed Statement on Subprime Mortgage Lending

A number of questions also have been raised concerning the underwriting and marketing of certain hybrid ARMs that are being made to subprime borrowers, commonly known as 2/28 and 3/27 ARMs, and sometimes referred to as "credit repair" loans. These products make up a significant portion of the subprime mortgages being originated today.[5]

[5] The 2/28 and 3/27 hybrid ARM products represented more than 60% of all subprime mortgages originated in 2006.

Hybrid ARM products feature fixed initial payments of principal and interest that reset in two or three years based on a variable interest rate plus margin formula. The reset margins on subprime hybrid ARM products are typically much higher, and interest adjustments more frequent, than on comparable prime loans. These circumstances, especially when they are combined with high periodic caps on how much the interest rate may increase and lower than normal initial payments, mean that a subprime borrower's payment may increase significantly and quickly, causing payment shock. The agencies are concerned that some lenders are not prudently evaluating the repayment capacity of borrowers by failing to consider the borrower's ability to service the debt when payments increase and to make housing-related tax and insurance payments. With some subprime mortgages, the terms of a prepayment penalty also can be onerous, which can make it very difficult or expensive for the borrower to refinance the loan in order to avoid unaffordable increases in monthly payments. These products present serious concerns that they are being offered to borrowers who may not understand the associated risks and who do not have the capacity to repay the loan as structured.

As noted above, the consequences of these loan structures can include an inability of the borrower to make payments after the initial rate adjustment, adding to the risk of default. Thus, these loan products raise some of the same concerns about appropriate underwriting, consumer protection, and the risks of payment shock that the agencies addressed with respect to nontraditional loan products in the NTM guidance. However, because hybrid ARM products generally provide for fully amortizing payment schedules, they were not specifically covered by the NTM guidance. [6]

[6] Depending upon the terms of a particular loan, the degree of payment shock for a payment option ARM can be greater than for a hybrid ARM, because payment option ARMs permit negative amortization.

The agencies determined that guidance was needed to address the specific concerns that had been raised with respect to certain subprime mortgage loans such as hybrid ARMs.[7] The proposed "Statement on Subprime Mortgage Lending" published by the agencies earlier this month addresses appropriate underwriting standards, measures to prevent predatory lending, and consumer disclosure practices for subprime ARM products that raise the concerns summarized above.

Like the NTM guidance, the proposed subprime mortgage lending statement specifies that an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The proposal explains that an institution's analysis of repayment capacity should include an assessment of the borrower's ability to repay total monthly housing expenses including real estate taxes and property insurance, in addition to principal and interest payments on the loan. The statement also provides that, in making its assessment of the borrower's income and ability to repay the loan, a lender generally should not rely on reduced documentation or stated income procedures. It further notes that most institutions should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

The proposed statement also describes the consumer protection principles that are fundamental to the underwriting and marketing of hybrid ARMs to subprime borrowers. These principles include providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select products and choose among payment options. Therefore, the guidance provides that consumers should

[7] Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10,533 (March 8, 2007).

receive clear and balanced information about the relative benefits and risks of the products, including information on:

- Potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires;
- The existence of any prepayment penalty, how it will be calculated, and when it may be imposed;
- The existence of any balloon payment;
- Whether there is a cost premium attached to a reduced documentation or stated income program; and
- The requirement to make payments for real estate taxes and insurance, if not escrowed, in addition to loan payments, and the fact that taxes and insurance costs can be substantial.

The proposed statement strongly encourages institutions that impose prepayment penalties to provide borrowers with sufficient time immediately prior to the reset date to refinance without penalty. And, it provides that institutions should not directly, or indirectly, through broker compensation systems, steer consumers to subprime mortgage products to the exclusion of other products offered by the institution for which the consumer may qualify.

The agencies have issued the Statement on Subprime Mortgage Lending as proposed guidance, and we are seeking public comment during the 60-day comment period that ends on May 7, 2007. We recognize that the market for providing mortgage loans to borrowers with impaired credit records has evolved rapidly in recent years, as have subprime mortgage products, in response to expanding home ownership opportunities, higher home prices in certain areas, competition by lenders for loan volume, developments in the secondary mortgage

market, and investor and borrower risk tolerances. Not all of these product developments have been benign, and thus there is a need for the agencies to address the concerns we have noted above. We believe that the underwriting and consumer protection principles contained in the proposed statement are responsive to the legitimate concerns that have been raised.

However, it is also important to note that we do not issue prescriptive underwriting standards lightly. In such cases, the government is effectively substituting its judgment on how institutions may assess credit risk for the judgment of market participants and the borrowers themselves. Moreover, in formulating underwriting standards, it can be very difficult to draw lines that will restrict "bad" credit without unintentionally restricting the availability of "good" credit. The subprime market presents unique issues and particular challenges in this regard, as has been noted in a number of recent news articles about deteriorating conditions in the subprime market.

Given the level of concern about the subprime market, questions have been raised about whether or not the agencies have responded with appropriate speed and diligence. We have also been asked why we did not apply the NTM guidance to subprime loans, since a characteristic common to both nontraditional mortgages and subprime hybrid ARMs is the risk of payment shock. I would like to address those questions now. The agencies ultimately decided to propose guidance on subprime hybrid ARM products as separate guidance, to focus public comment on the particular issues raised by this type of lending. In doing so, we hope to be able to evaluate how the application of borrower qualification standards like those contained in the NTM guidance will affect subprime borrowers in particular, and whether other standards should be considered that may be more appropriate or effective in some circumstances. As noted earlier, loan performance data for subprime loans originated in 2006 show a sharp

increase in delinquencies, as compared to subprime loans originated in the preceding four years. With respect to whether or not the agencies are reacting with appropriate speed to address underwriting deficiencies suggested by the performance of recent vintage hybrid ARMs, it is true that our course of action to issue separate guidance following a public comment process has the disadvantage of not immediately responding with final guidelines affecting new originations. However, it will permit us to proceed in a better informed manner in addressing issues that may be unique to subprime borrowers and their access to credit.

For example, in recent years, lending institutions have been encouraged to reach out to the subprime market to provide greater access to credit, in connection with their obligations under the Community Reinvestment Act, and in a manner consistent with safe and sound lending principles. As noted earlier, these efforts have been instrumental, and highly effective, in expanding homeownership for these borrowers and in fueling economic growth. In this regard, it is important to note that the borrower qualification standards contained in the proposal are likely to result in fewer subprime borrowers qualifying for home loans, and there is no guarantee that such borrowers will be able to qualify for other loans in the same amount if the standards are adopted. Thus, as compared to the standards for prime and near-prime loans contained in the NTM guidance, imposing strict borrower qualification standards on subprime loans has the inherent risk that borrowers could be denied access to types of credit that represent their only way to finance a home purchase. The application of these standards to existing subprime borrowers with hybrid ARMs, who want to refinance their loans in order to avoid unaffordable payment increases, can raise particular challenges and questions of fairness if they are unable to do so.

We also recognize that some products have been introduced that are intended to serve as temporary credit accommodations, rather than long-term financing vehicles. At origination, these loans may involve terms that exceed the borrower's present ability to service the debt. The motivations for these arrangements vary, but sometimes they include providing a home purchase loan to a borrower who intends to use the property only temporarily, for whom there is expected future earnings growth, or for whom there is a need for affordable payments in the short term, in order to improve the borrower's credit history. Indeed, a recent survey involving an admittedly small sample of these loans found that a number of the products have been used for credit repair, enabling at least some borrowers to refinance their subprime hybrid ARMs to either prime loans or subprime fixed-rate products. Thus, these loans can operate as de facto balloon payment loans that may be appropriate in certain circumstances.

In light of these considerations, we are particularly interested in public comment on whether the proposed statement appropriately balances the need for changes in underwriting standards with the need to prevent an undue constriction in credit availability for creditworthy borrowers. Therefore, we have asked for comment on whether the loans described in the statement always present inappropriate risks to lenders or borrowers that should be discouraged, or alternatively, when and under what circumstances they may be appropriate. In addition, as noted above, we are concerned about the impact of the proposed standards on borrowers who currently hold such loans, and we seek comment on whether the standards, if adopted, will unduly restrict the ability of these existing borrowers to refinance their loans and avoid payment shock.

We are also concerned about the possibility of an "unlevel regulatory playing field" if already highly-regulated, federally-regulated institutions are subject to stricter standards on

subprime mortgage lending, but state-licensed nonbank lenders are not. This is a particular concern because, as noted earlier, state-licensed nonbank lenders and brokers play a predominant role in the subprime market. In this regard, we appreciate the recent announcement by the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) of their intention to seek adoption by state regulatory agencies of comparable subprime lending standards when the federal agency guidance is finalized. This approach is consistent with the undertakings by the CSBS and AARMR in connection with state-by-state adoption of the federal agency NTM guidance. Many states have not yet applied the NTM guidelines to state-licensed lenders and brokers -- including several states with major real estate markets. However, we are encouraged that agencies in a number of states *have* adopted them.[8] Similarly, we think that it is important that the basic principles embodied in our subprime lending guidance are also adopted by secondary market participants who purchase such loans. We note that Freddie Mac recently issued guidance comparable to the proposed Statement on Subprime Mortgage Lending concerning the eligibility of hybrid ARM products for purchase,[9] although to date, there have not been similar moves by other major securitizers. As mentioned at the outset, we believe that adopting and implementing consistent standards across *all* segments of the mortgage lending industry is crucial to promoting sound loan underwriting and to helping consumers understand the material terms and risks of these loan products.

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[8] *See* www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/State_Implementation.htm.

[9] *See* News Release, Freddie Mac, "Freddie Mac Announces Tougher Subprime Lending Standards to Help Reduce the Risk of Future Borrower Default; Company Also to Develop Model Subprime Mortgages" (Feb. 27, 2007), *available at* www.freddiemac.com/news/archives/corporate/2007/20070227_subprimelending.html; *see also* Letters from J.B. Lockhart, III, Director, Office of Federal Housing Enterprise Oversight to R.F. Syron, Chairman and CEO, Freddie Mac, and D.H. Mudd, President and CEO, Fannie Mae (Dec. 8, 2006) (requesting a report on the steps taken in response to interagency guidance on nontraditional mortgage products), *available at* www.ofheo.gov/media/pdf/ NontraditionalMortgage121306.pdf. Another important improvement in the secondary market would be enhanced investor disclosures that state whether or not mortgages in the pools backing the securities are in compliance with federal banking agency guidelines on nontraditional mortgage products and subprime lending, as applicable.

There is evidence that some lenders are already revising their underwriting practices in response to deteriorating market conditions and increasing risks, delinquencies, and foreclosures involving subprime mortgage loans. In light of these developments, it is imperative that the agencies develop final guidelines on subprime mortgage lending that are carefully calibrated to try to ensure that consumers are protected against undue risks while avoiding unintended adverse consequences both to credit availability *and* to mortgage markets.

In this regard, we received a letter from twenty-three members of the House Committee on Financial Services expressing concern about rapidly rising foreclosure rates involving nontraditional and subprime loans, and encouraging lenders to exercise flexibility in dealing with delinquent borrowers who seek to work out, or refinance, these loans in order to avoid unaffordable payment increases. The OCC believes that it is in the best interests of both lenders and borrowers to work together to bring a loan current and to avoid foreclosure whenever possible. Reasonable workout arrangements are an appropriate and productive way to assist borrowers who have encountered financial difficulties. Let me assure you that national banks are encouraged to engage in responsible loan workout and recovery activities in order to avoid a foreclosure and they will not face regulatory criticism for such activities. [10]

Moreover, the OCC recognizes the need for all lenders to engage in foreclosure prevention efforts and we have been very proactive in communicating our views to national banks on this issue and on "best practices" for foreclosure prevention.[11] Among the best practices for effective foreclosure prevention is having a full-cycle approach to borrower

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[10] See letter, dated March 14, 2007, from John C. Dugan, Comptroller of the Currency, Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, John M. Reich, Director, Office of Thrift Supervision, and JoAnn Johnson, Chairman, National Credit Union Administration to Barney Frank, Chairman, Committee on Financial Services, United States House of Representatives, responding to these concerns.

[11] *See* "Homeownership: Preserving the American Dream," by John C. Dugan, Comptroller of the Currency, *Community Developments*, Spring 2006.

financial counseling -- before, during, and after taking out a mortgage, and at the first sign of repayment problems. In this regard, the OCC issued guidance to national banks on strategies for effective delinquency intervention activities in affordable mortgage portfolios held by national banks.[12] The OCC, along with the U.S. Department of Housing and Urban Development (HUD) and the other bank regulators, serves on the board of NeighborWorks America, a national non-profit organization. The NeighborWorks Center for Foreclosure Solutions, its national foreclosure center, has developed very effective foreclosure prevention strategies and foreclosure intervention programs in communities across the country. The OCC has encouraged national banks to work to reduce foreclosures through partnerships with nonprofit organizations, like the NeighborWorks Center. We have also advised national banks that when they participate in foreclosure avoidance counseling programs targeted to low- and moderate-income borrowers in their assessment areas, they will receive Community Reinvestment Act credit.

Finally, the OCC is joining with other federal bank regulatory agencies in holding a forum on April 16th to discuss current issues in the mortgage market, including the need for foreclosure mitigation strategies.

OCC Regulations and Federal Laws Relating to Predatory Lending Practices

OCC Regulations

There is scant evidence that national banks or their subsidiaries are engaging in predatory lending practices. Nevertheless, the OCC has taken a number of significant steps

[12] *See* OCC Advisory Letter 97-7, Affordable Mortgage Portfolios.

directed at ensuring that national banks do not become involved in unfair, deceptive, or predatory practices. Through the issuance of supervisory guidelines and regulations, and through enforcement actions, we have acted to deter abusive lending practices and ensure fair treatment of national bank customers.

The OCC was the first federal banking agency to issue comprehensive anti-predatory lending guidance and anti-predatory lending regulations specifically applicable to the institutions we supervise -- national banks and their operating subsidiaries. Early in 2004, the OCC adopted regulations that address a fundamental characteristic of predatory lending – equity stripping.

For example, under OCC rules, national banks are *prohibited* from making mortgage loans based predominantly on the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms.[13] In addition, while the OCC does not have the authority to issue regulations defining the specific acts and practices that are unfair or deceptive, and therefore unlawful under the Federal Trade Commission Act (FTC Act),[14] OCC regulations do prohibit national banks from engaging in any lending practice that would be unfair or deceptive within the meaning of the FTC Act.[15]

In 2005, the OCC issued additional regulatory standards for national banks to avoid potentially predatory lending practices in direct loan originations, loan purchases, and brokered transactions. These standards are entitled "Guidelines Establishing Standards for Residential

[13] 12 C.F.R. §§ 7.4008(b) and 34.3(b).
[14] The Federal Reserve Board has exclusive authority to issue regulations that define the practices that are unfair or deceptive for banks under the FTC Act. 15 U.S.C. 57a(f)(1).
[15] 12 C.F.R. §§ 7.4008(c) and 34.3(c).

Mortgage Lending Practices" (Part 30 guidelines).[16] The Part 30 guidelines were drawn from principles contained in advisory letters on the same subjects that the OCC issued in 2003,[17] but unlike the advisory letters, are enforceable under section 39 of the Federal Deposit Insurance Act.[18] In issuing the Part 30 guidelines, we recognized that "[f]air treatment of customers is fundamental to sound banking practices."[19] The Part 30 guidelines were designed to protect against involvement by national banks, either directly or through loans that they purchase or make through intermediaries, in lending practices that can injure national bank customers and expose the bank to credit, legal, compliance, reputation, and other risks.

Significantly, the Part 30 guidelines identify particular practices in which national banks should *not* become involved, either directly or through brokered or purchased loans:

- equity stripping and fee packing;
- loan flipping;
- encouragement of default on an existing loan; and
- refinancing of special subsidized mortgages with loans that do not provide a tangible economic benefit to borrowers relative to the refinanced loans.[20]

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[16] 12 C.F.R. Part 30, App. C.

[17] Because of the importance of mortgage lending to the nation's economy and to individual consumers, as well as the devastating consequences of predatory mortgage lending, the OCC issued two detailed advisory letters – one focused upon mortgage origination standards and the other addressing the special problems presented by brokered or purchased loans – that were designed to help national banks avoid ever engaging in predatory practices in their mortgage lending activities. OCC Advisory Letter 2003-2, "Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices" (Feb. 21, 2003) and OCC Advisory Letter 2003-3, "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans" (Feb. 21, 2003). These advisory letters expanded upon earlier advisories relating to abusive lending practices and the legal standards the OCC would use in determining whether practices are unfair or deceptive. *See* Advisory Letter 2000-7, "Abusive Lending Practices" (July 25, 2000); Advisory Letter 2002-3, "Guidance on Unfair or Deceptive Acts or Practices" (March 22, 2002).

[18] 12 U.S.C. § 1831p-1; *see also* 12 C.F.R. §§ 30.3 - .6.

[19] 70 Fed. Reg. 6329 (Feb. 7, 2005).

[20] 12 C.F.R. Part 30, App. C at III (A)(1) – (4).

The guidelines also address a second category of loan terms and features that the OCC recognized may in some circumstances be susceptible to predatory, unfair or deceptive lending risks, and yet may be appropriate risk mitigation measures in other circumstances. These practices or features are:

- financing single premium credit insurance;
- negative amortization;
- balloon payments in short-term transactions;
- prepayment penalties not limited to the early years of a loan;
- interest rate increases on default at a level not commensurate with risk mitigation;
- provisions allowing the bank to accelerate payment of the loan in circumstances other than the borrower's default or to mitigate loss;
- the absence of an appropriate assessment and documentation of the consumer's ability to repay the loan in accordance with its terms;
- mandatory arbitration clauses;
- pricing terms that trigger HOEPA;
- extending a loan in which the principal balance exceeds the appraised value of the property;
- payment schedules that consolidate more than two periodic payments and pay them in advance from the proceeds; and
- payments to a home improvement contractor from proceeds of a mortgage loan other than to the consumer, the consumer and contractor jointly, or to a third-party escrow agent. [21]

[21] *Id.* at III(B)(1) – (12).

Pursuant to these mortgage lending guidelines, national banks must prudently consider the circumstances, including the characteristics of the targeted market and applicable consumer protection and safety and soundness safeguards, under which the bank will make residential mortgage loans with the terms and features outlined above. A national bank is expected to exercise enhanced care and to apply heightened internal controls and monitoring when making loans with these features to borrowers who are not financially sophisticated or whose credit choices are limited.[22]

As noted above, the Part 30 guidelines apply to mortgages that national banks and their subsidiaries originate directly, as well as mortgages that they purchase or make through a broker or other intermediary. The guidelines thus address concerns that have been raised about the link between predatory practices and non-regulated lending intermediaries, as well as concerns that a national bank could inadvertently facilitate predatory lending through the purchase of loans and mortgage-backed securities and in connection with mortgage broker transactions.

The Part 30 guidelines provide that indirect lending activities by national banks should reflect standards and practices consistent with those applied by the bank in its direct lending activities.[23] Thus, these guidelines specify measures that banks should undertake, such as establishing criteria for entering into and continuing third-party relationships, underwriting and appraisal requirements, compensation standards, appropriate third-party agreements, and criteria for taking appropriate corrective action in the event the bank's policies are not

[22] *Id.* at III(C). Consistent with the OCC's general emphasis on strong consumer disclosure practices and the avoidance of unfair or deceptive practices, the Part 30 guidelines also establish high expectations for the provision of relevant information to consumers. In particular, the Part 30 guidelines provide that national banks should give "timely, sufficient, and accurate information to a consumer concerning the costs, risks, and benefits of the loan," including information "sufficient to draw their attention to these key terms." *Id.* at III(D).
[23] *Id.* at III(E).

followed.[24] They also provide that national banks should take appropriate steps to ensure that compensation policies for brokers do not provide incentives for originating loans with potentially predatory terms and conditions. In addition, the guidelines provide that a national bank should engage in appropriate monitoring and oversight of its third-party originations to ensure that the bank's residential mortgage lending activities comply with applicable law and the bank's internal standards.[25] This rigorous and detailed OCC guidance will remain applicable to all mortgage lending in national banks and their subsidiaries in addition to the interagency issuances in this area.

Applicable Laws

In addition to OCC regulations, several federal laws apply to the mortgage lending operations of national banks and can be enforced as necessary to address instances of unfair, deceptive, or predatory mortgage lending practices. These laws, and the agencies responsible for issuing and interpreting related regulations, include:

- The Home Ownership and Equity Protection Act of 1994 (HOEPA)),[26] which provides enhanced consumer protections with respect to certain high-cost mortgages and directs the Federal Reserve Board to issue such additional regulations as necessary to address unfair, deceptive, or abusive mortgage lending practices (Federal Reserve Board);
- Section 5 of the Federal Trade Commission Act (FTC Act), which prohibits unfair or deceptive acts or practices and directs the Federal Reserve Board to define by

[24] *Id.* at III(E)(1) – (6).
[25] *Id.* at III(F).
[26] 15 U.S.C. § 1601 *et seq.*; *see also* 12 C.F.R. Part 226.

regulation such practices that are unlawful for banks (Federal Reserve Board for banks; Office of Thrift Supervision (OTS) for thrifts);[27]

- The Equal Credit Opportunity Act (ECOA),[28] which prohibits discrimination against applicants based on race, color, religion, national origin, sex, marital status, age, the receipt of public assistance income, or the exercise of rights under the Consumer Credit Protection Act in any aspect of a credit transaction (Federal Reserve Board);
- The Fair Housing Act,[29] which prohibits discrimination based on race, color, religion, sex, handicap, familial status, or national origin in making a residential real estate-related transaction available (HUD);
- The Truth in Lending Act (TILA),[30] which requires creditors to provide disclosures about terms and costs of credit (Federal Reserve Board); and
- The Real Estate Settlement Procedures Act (RESPA),[31] which requires advance disclosure of settlement costs in residential real estate transactions and prohibits kickbacks or unearned fees for settlement services (HUD).

OCC Supervisory Process

The OCC conducts comprehensive examinations of national banks to ensure that they operate in a safe and sound manner and in accordance with the applicable laws, regulations, and supervisory directives described above. Through a network of approximately 1,800 examiners located throughout the United States and in London, we monitor conditions and trends, both in individual banks and in the banking system as a whole. Our supervisory

[27] 15 U.S.C. § 45. The OCC's ability to enforce this prohibition against national banks and their operating subsidiaries has been upheld in the courts. *See* Roberts v. Fleet Bank, 342 F.3d 260, 270 (3d Cir. 2003); Chavers v. Fleet Bank, 844 A.2d 666, 674-676 (R.I. 2004).
[28] 15 U.S.C. § 1691 *et seq.*; *see also* 12 C.F.R. Part 202.
[29] 42 U.S.C. § 3601 *et seq.*; *see also* 24 C.F.R. Part 100.
[30] 15 U.S.C. § 1601 *et seq.*; *see also* 12 C.F.R. Part 226.
[31] 12 U.S.C. § 2601 *et seq.*; *see also* 24 C.F.R. Part 3500.

activities focus on the risks as identified by our supervisory monitoring tools and subject matter experts. At the largest banks, on-site examination teams continuously monitor all aspects of the banks' operations.

The OCC supervises national banks by business line, not according to corporate form, so the standards applied in the course of that supervision are the same for national banks and their operating subsidiaries.

National banks are regularly examined for safety and soundness and for compliance with applicable consumer protection laws and regulations. The OCC reviews the adequacy of the bank's policies, systems, and controls relative to the character and complexity of the bank's business, and assesses whether the bank's activities are being carried out in compliance with applicable laws and regulations. As part of these reviews, examiners sample individual transactions to validate their assessment of the bank's systems, controls, and legal compliance.

Depending on the bank's risk profile and other supervisory information, including consumer complaints, examiners may target their reviews to a particular loan product, business line, or operating unit. For example, if the institution is engaging in significant new or expanded mortgage lending activities, examiners ordinarily would pay particular attention to those loans during their review. If the sampling process indicates potential issues, examiners will expand their review as appropriate. The examination process is intended to provide a high level of assurance that each aspect of an institution's business is conducted in compliance with applicable laws and on a safe and sound basis.

As indicated above, consumer complaints filed with our Customer Assistance Group (CAG) may raise red flags concerning potential predatory lending. CAG staff are responsible for assisting customers of national banks and their subsidiaries by answering questions and resolving individual complaints. When CAG receives a written, signed complaint, it requests a response from the bank involved, and may request additional information from the consumer or the bank. Additionally, CAG personnel may, and often do, consult with OCC's bank supervision and Law Department personnel to help ensure that complaints are resolved appropriately and, where applicable, any identified violations of law are fully addressed.[32] After evaluating the information before it, CAG sends the consumer a letter containing its findings. Over the last five years, from 2002 to 2006, national bank customers received more than $3,500,000 in financial relief in connection with resolution of individual mortgage-related complaints filed with CAG.

CAG also provides data to examiners to help flag banks, activities, and products that require further investigation, and to OCC management and others to assist in identifying trends and emerging problems. If predatory or abusive lending issues surface in the course of these examinations or are otherwise brought to examiners' attention through consumer complaints or other sources, examiners and OCC attorneys determine whether the practices in question violate any applicable laws and regulations, including the FTC Act, HOEPA, or the OCC's Part 30, or are otherwise inconsistent with OCC guidelines and mortgage lending standards. In cases where such a determination is made and depending upon the circumstances, the OCC will either obtain appropriate corrective action informally through the supervisory process or formally through an enforcement action, as described below.

[32] Complaints that allege or raise issues of predatory lending or unfair or deceptive practices are generally reviewed by CAG personnel in close consultation with the OCC's Law Department.

The OCC's bank supervision process can result in significant reforms to bank practices and keep banks on a proper course even in the absence of litigation, formal enforcement actions, or other publicized events. The OCC's examiners exert extraordinary authority and influence over the activities of national banks through the supervisory process. When examiners identify an issue, they expect it to be fixed promptly, without having to resort to a formal enforcement action, and the agency can use a wide range of measures short of formal, public enforcement actions to obtain the desired result. Such measures include communications of "matters requiring attention" in confidential examination reports to bank management and boards of directors and informal enforcement actions such as nonpublic memoranda of understanding.

The vast majority of supervisory problems are promptly corrected through informal means. In some cases, however, a formal enforcement action may be necessary based on the nature or gravity of an issue or the nature of the remedies sought to address instances of unfair, deceptive, or predatory lending practices. In such cases, as described below, we do not hesitate to bring an enforcement action when appropriate.

Enforcement Actions

Congress has provided the OCC with a wide range of methods to address unsafe or unsound practices or violations of laws, rules, or regulations. Section 8 of the Federal Deposit Insurance Act gives the OCC broad powers to compel compliance with any law, rule, regulation, written agreement or condition imposed in writing. The OCC may initiate cease and desist proceedings, seek civil money penalties, and, as appropriate, seek restitution or reimbursement for affected customers if the OCC determines that a national bank or its

operating subsidiary has violated any applicable federal law or regulation or any applicable state law or regulation.[33]

The OCC was the first federal banking agency to take enforcement action against an institution it supervises for violations of Section 5 of the FTC Act. In a groundbreaking case, the OCC asserted section 5 of the FTC Act as a basis for seeking a cease and desist order, as well as affirmative remedies, against a national bank in 2000. Since that time, the OCC has taken several more formal enforcement actions against national banks found to be engaging in unfair or deceptive practices within the meaning of the FTC Act. These cases have involved issues ranging from misleading and deceptive advertising of credit cards and ancillary products to unfair mortgage practices.[34]

To date, the OCC has charged FTC Act violations in two cases to obtain reimbursement for mortgage loan borrowers who were harmed by predatory or unfair practices. In a consent order entered into in 2003, we required a bank to provide restitution to borrowers who were affected by unfair practices in connection with tax lien loans. We found that fees for these loans were imposed for services that were not performed, and that the bank also violated federal legal requirements in TILA, HOEPA, RESPA, and the FTC Act. Consumers who were harmed by the bank's practices were provided restitution in the amount of all fees paid in connection with the loans – whether or not characterized as a finance charge under TILA and whether paid to the bank or to a third party, and all interest charges.

In 2005, the OCC entered into a formal agreement requiring another bank to establish a $14 million fund to reimburse consumers who were harmed by the lack of appropriate controls

[33] 12 U.S.C. § 1818. This statute also permits the OCC to pursue remedies based on unsafe or unsound banking practices.
[34] *See* Attachment B.

in the bank's mortgage lending operations and practices. Consumers entitled to restitution included consumers who: (1) paid origination fees and/or interest rates substantially different from those indicated on good faith estimates; (2) did not have their creditworthiness adequately considered; or (3) held a subsidized loan that was refinanced with a higher cost loan that did not appear to provide the consumer with a tangible economic benefit. The agreement also required the bank, among other things, to ensure that its advertising materials adequately disclose limitations or conditions on various products and to develop a detailed consumer compliance program to ensure compliance with the FTC Act, RESPA, the OCC's Part 30 guidelines, and the OCC's other issuances regarding abusive, predatory, unfair, or deceptive practices.

Conclusion

In conclusion, this hearing is an important opportunity to examine the issues confronting the subprime mortgage market, including the very serious concerns that have been raised about loan underwriting practices, consumer protection, and deteriorating loan performance. Even though subprime lending engaged in by national banks under the OCC's supervision accounts for a small percentage of the overall market for such loans, we nevertheless believe that it is important that the federal banking agencies and state agencies continue to work together to address these concerns to the extent they arise in the institutions we supervise. In going forward, we should all be cognizant of the need to find an approach that not only addresses these concerns without unintended adverse consequences to consumers or to credit markets, but that also is fairly applied and consistently implemented for all of the providers of subprime mortgage finance.

I appreciate the opportunity to present the OCC's views on these issues and will be pleased to answer any questions that you might have.

Attachment A

List of OCC Supervisory Guidance Documents on Abusive Lending Practices

- Advisory Letter 2000-7, "Abusive Lending Practices" (July 25, 2000)
- Advisory Letter 2000-10, "Payday Lending" (Nov. 27, 2000)
- Advisory Letter 2000-11, "Title Loan Programs" (Nov. 27, 2000)
- Advisory Letter 2002-3, "Guidance on Unfair or Deceptive Acts or Practices" (March 22, 2002)
- Advisory Letter 2003-2, "Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices" (Feb. 21, 2003)
- Advisory Letter 2003-3, "Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans" (Feb. 21, 2003)
- Advisory Letter 2004-4, "Secured Credit Cards" (April 28, 2004)
- Advisory Letter 2004-10, "Credit Card Practices" (Sept. 14, 2004)
- Joint Guidance on Overdraft Protection Programs (Feb. 18, 2005)
- Interagency Guidance on Nontraditional Mortgage Product Risks (Oct. 4, 2006)
- Interagency Statement on Subprime Mortgage Lending (Proposed March 8, 2007)

Attachment B

List of Public Enforcement Actions under the FTC Act

- Consent order – June 28, 2000. We required the bank to set aside not less than $300 million for restitution to affected consumers and to change its credit card marketing program, policies, and procedures.

- Consent order – May 3, 2001. We required the bank to provide restitution of approximately $3.2 million and to change its credit card marketing practices.

- Consent order – December 3, 2001. We required the bank to set aside at least $4 million for restitution to affected consumers and to change its marketing practices.

- Formal agreement – July 18, 2002. We required the bank to change its marketing practices.

- Consent order – January 17, 2003. We required the bank to set aside at least $6 million for restitution to affected consumers, to obtain prior OCC approval for marketing subprime credit cards to non-customers, to cease engaging in misleading and deceptive advertising, and to take other actions.

- Formal agreement – March 25, 2003. We required the bank to provide restitution in connection with private label credit card lending and to make appropriate improvements in its compliance program.

- Formal agreement – July 31, 2003. We required the bank to provide refunds of approximately $1.9 million to affected consumers in connection with credit card practices.

- Consent order – November 7, 2003. We required the bank to set aside at least $100,000 to provide restitution for borrowers who received tax lien loans, review a portfolio of mortgage loans to determine if similar violations existed, and take steps to prevent future violations.

- Consent order – May 24, 2004. In a second case involving the same bank, we required the bank to set aside at least $10 million for restitution to affected consumers and prohibited the bank from offering secured credit cards in which the security deposit is charged to the consumer's credit card account.

- Formal agreement – November 1, 2005. We required the bank to set aside at least $14 million for restitution to affected customers and to strengthen internal controls to improve compliance with applicable consumer laws and regulations and underwriting standards.

For release on delivery
10:00 a.m. EDT
March 27, 2007

Statement of

Sandra F. Braunstein

Director, Division of Consumer and Community Affairs

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

U.S. House of Representatives

March 27, 2007

Madam Chair Maloney, Ranking Member Gillmor, members of the Subcommittee, I appreciate the opportunity to discuss how current subprime practices and products affect homeownership and foreclosures, and the interagency proposed guidance on subprime mortgage lending. Recent reports on delinquencies and foreclosures in the subprime market underscore the need for clarity regarding these matters and you are to be commended for holding this hearing today.

My testimony will discuss the recent increases in delinquencies and foreclosures in the subprime mortgage market and some of the developments that may have contributed to these increases. I will discuss the Federal Reserve Board's ongoing efforts as a banking supervisor to ensure that the institutions we supervise are managing their mortgage lending activities in a safe and sound manner, including assessing the repayment capacity of borrowers. I will also discuss several steps the Board has undertaken to strengthen protections for consumers, including subprime borrowers, and I will discuss those efforts as well as our plans to continue this work in the near and longer term. Finally, I will highlight our work through our Community Affairs function to support foreclosure prevention through approaches such as education and outreach to troubled borrowers at risk of losing their homes.

The Growth of the Subprime Market and the Recent Increase in Delinquencies and Foreclosures

Mortgages and the Role of the Capital Markets

The banking system has changed dramatically since the mid-1970s. Then, banks and savings and loans used their deposit base and other funding sources to finance, originate, and hold loans to maturity. These financial institutions were highly exposed to their local community residential markets, and their analysis of credit risk was generally limited to reviews

of individual loans. Home mortgages had fixed rates and there were few alternative products available to consumers.

Today, the mortgage lending business has changed dramatically with the development of national markets for mortgages, technological changes, and the advent of securitization. The traditional book-and-hold model of mortgage lending has shifted to an originate-to-distribute model. While commercial banks still have a significant role in the mortgage origination and distribution process, they are no longer the leading originators or holders of residential mortgages. Securitization has allowed many financial institutions to use increasingly sophisticated strategies to package and resell home mortgages to investors. This has resulted in increased competition and a wide variety of mortgage products and choices for consumers, in a market in which mortgage brokers and mortgage finance companies compete aggressively with traditional banks to offer new products to would-be homeowners.

These innovations mean that insured depository institutions are now able to manage liquidity and control credit concentrations, maturities, and loan balances in portfolios much more than they could in the past through the use of financial instruments such as mortgage-backed securities. For capital market investors, securitization has reduced transaction costs, increased transparency, and increased liquidity.

The Growth of the Subprime Market and Increased Opportunities for Homeownership

One of the products of this new mortgage market is subprime lending.[1] Subprime lending has grown rapidly in recent years. In 1994, fewer than 5 percent of mortgage originations were subprime, but by 2005 about 20 percent of new mortgage loans were subprime. The expanded access to subprime mortgage credit has helped fuel growth in homeownership. The national rate of homeownership increased from 1995 through 2006, from 65 percent to nearly 69 percent of all households. This means that nearly 67 million households now own homes, compared to roughly 64 million 10 years ago. All major racial and ethnic groups have made gains in homeownership, but in percentage terms the largest increases have been made by minority households. In particular, from 1995 to 2006 the homeownership rate has increased by 7 percent among white households, 13 percent among African American households, and 18 percent among Hispanic households. Significantly, the Federal Reserve's Survey of Consumer Finances indicates that, from 1995 to 2004, census tracts in all income groups experienced gains in homeownership, with rates in lower-income areas growing by 6 percent, somewhat faster than the 4 percent growth rate in higher-income areas.

[1] The term "subprime" generally refers to borrowers who do not qualify for prime interest rates because they exhibit one or more of the following characteristics: weakened credit histories typically characterized by payment delinquencies, previous charge-offs, judgments, or bankruptcies; low credit scores; high debt-burden ratios; or high loan-to-value ratios. Prime borrowers represent more than 75 percent of the 43 million first-lien mortgage loans outstanding in the United States; subprime borrowers represent about 13 or 14 percent; and the remaining borrowers fall within a somewhat loosely defined category between prime and subprime known as "Alt-A," or "near-prime," which is designed for borrowers with good credit records who do not meet standard guidelines for documentation requirements, debt-to-income ratios, or loan-to-value ratios.

Explaining Increased Delinquencies and Foreclosures

The rise in subprime foreclosures from the multi-year lows they hit in the middle of 2005 is in part a consequence of broader economic conditions including rising interest rates and slowing house price growth. Until recently, borrowers with adjustable rate mortgages could cope with payment increases by refinancing or in some cases selling, because of rapid house price appreciation.

In 2006, however, mortgage interest rates hit four-year highs, the volume of home sales declined and the rate of house price appreciation decelerated or in some cases home prices fell, leaving the most recent subprime borrowers vulnerable to payment difficulties. Subprime borrowers with ARMs have experienced the largest recent increase in delinquency and foreclosure rates, while prime borrowers experienced almost no increase in delinquencies and foreclosures. Borrowers may not be able to avoid sharp payment increases as they could in earlier years. Even borrowers with enough equity to refinance their adjustable rate mortgages may face difficulty finding a loan with affordable payments, as interest rates are higher than in earlier years. However, with long-term rates unusually low relative to short-term rates, this problem is not as acute as it would be under a historically more normal configuration of interest rates.

Moreover, an unusually large number of subprime loans have defaulted shortly after origination. In many of these "early payment defaults," borrowers stopped making payments before they faced payment shocks, suggesting that in 2006 some lenders may have lowered their underwriting standards in the face of reduced borrower demand for credit. Because of the rapid expansion of subprime lending in recent years, lenders, investors, and ratings agencies had limited data with which to model credit risk posed by new borrowers or novel mortgage types,

and so may have underestimated the risk involved. Several lenders have already been forced out of the subprime market, in part because of the wave of early payment defaults on mortgages they originated.

Although there are some indications that the market is correcting itself, we remain concerned that over the next one to two years, existing subprime borrowers, especially those with more recently originated ARMs, may face more difficulty. They are likely to continue to experience elevated delinquency and foreclosure rates as these loans reach their interest rate reset point and they are faced with larger monthly payments.

The Board's Responses to this Growing Market

Over the past several years, the Federal Reserve has monitored developments in subprime lending. At the same time that subprime lending has increased homeownership, it has also been associated with higher levels of delinquency, foreclosure, and, in some cases, abusive lending practices. While these are serious problems, the Board believes they need to be addressed in a way that preserves incentives for responsible subprime lenders so that borrowers with non-prime credit can become homeowners or access the equity in their homes, or have flexibility in refinancing their mortgages when necessary. It is important that any actions we might take in response to these market outcomes are well calibrated and do not have unintended consequences. Constricting the market and returning to a situation where some borrowers have very limited access to credit is not an ideal solution. We want to encourage, not limit, mortgage lending by responsible lenders. I would like to discuss how we approach these issues through supervision, examination, guidance and regulation.

Supervisory Activities

Examination and Enforcement

The Federal Reserve conducts regular examinations of its institutions for both safety and soundness and compliance with consumer protection laws. We examine the mortgage businesses of the banks and bank holding companies that we supervise, including subprime residential portfolios.

Safety and soundness examinations include a review of credit risk-management practices such as underwriting, portfolio risk management, and quality control processes concerning third-party originations. In addition, examiners review stress testing, economic capital methods, and other quantitative risk-management techniques to ensure that banks are assessing the level and nature of these risks appropriately; asset securitization activity to ensure appropriate risk management and capital treatment; residential lending appraisal practices to ensure appropriate collateral valuation processes; and new product review processes to ensure that disciplined approaches are being brought to new lending products and programs.

Regular examinations for compliance with consumer protection laws are also conducted by a specially trained cadre of examiners. The scope of these examinations includes a review of the bank's compliance with the Truth in Lending Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act, the Community Reinvestment Act, and other federal consumer protection laws.

Where Federal Reserve examiners observe weaknesses or noncompliance in the practices of supervised institutions, examiners document them in a report to bank management. Corrective action is requested in the examination report and we find that bank management in most cases voluntarily addresses violations or weaknesses without the need for formal

enforcement actions. In those rare instances where the bank is not willing to address the problem, we have a full range of powerful enforcement tools at our disposal to compel corrective action. I have listed the enforcement actions we have taken in an appendix to my testimony. These actions may appear to be few in number, but that is because in the overwhelming majority of cases bank management corrects the weakness or problem without our having to compel them to do so. It is also due to the fact that our institutions are not heavily engaged in subprime lending.

Guidance and Regulations

We have issued several pieces of guidance in concert with the other agencies to address weaknesses in underwriting and risk management at the institutions we supervise. We have also revised regulations to address concerns about abusive practices; those regulations apply broadly throughout the mortgage industry.

Interagency Guidelines for Real Estate Lending. The foundation for much of the guidance we have issued throughout the last decade is the 1993 *Interagency Guidelines for Real Estate Lending,* which was issued pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). FDICIA required the federal banking agencies to prescribe uniform real estate lending standards. The final rule requires every depository institution to establish and maintain comprehensive, written real estate lending policies that are consistent with safe and sound banking practices. A key point in this document is that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt.

Expanded Subprime Guidance. The 1999 *Interagency Guidance on Subprime Lending*, originally issued in 1999 and expanded in 2001, discusses essential components of a

well-structured risk-management program for subprime lenders. This guidance emphasizes that lending standards should include well-defined underwriting parameters such as acceptable loan-to-value ratios, debt-to-income ratios, and minimum acceptable credit scores. It advises that institutions actively involved in the securitization and sale of subprime loans should develop contingency plans that include alternate funding sources and measures for raising additional capital if investors lose their appetite for certain risks.

The subprime guidance, as amended in 2001, also addresses concerns about predatory or abusive lending practices. The agencies recognized three common characteristics of predatory lending, including making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation; inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); or engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower. The guidance advises institutions that higher fees and interest rates, combined with compensation incentives, can foster predatory pricing or discriminatory practices, and that institutions should take special care to avoid violating fair lending and consumer protection laws and regulations. The agencies expressed the expectation that institutions should recognize the elevated levels of credit and other risks arising from subprime lending activities and that these activities require more intensive risk management and, often, additional capital. The guidance also states that loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Where risk-anagement practices are deemed deficient, the guidance advises examiners to criticize bank management and to require corrective actions.

2001 Revisions to HOEPA Rules. In 1994, Congress enacted the Home Ownership and Equity Protection Act (HOEPA) as an amendment to the Truth in Lending Act (TILA), in response to testimony before Congress about predatory home equity lending practices in underserved markets, where some lenders were making high-rate, high-fee home equity loans to cash-poor homeowners. HOEPA identifies a class of high-cost mortgage loans through criteria keyed to the loans' rates and fees and requires creditors to provide enhanced disclosures of, and to comply with substantive restrictions on, the terms of those loans. The Board implemented HOEPA through revisions to TILA rules effective in 1995.

In 2001, the Board revised the HOEPA rules in response to renewed concerns about predatory lending. The 2001 rule changes, effective in 2002, extended HOEPA's protections to more high-cost loans and strengthened HOEPA's prohibitions and restrictions, including by requiring that lenders generally document and verify a consumer's ability to repay a high-cost mortgage loan. In addition, the rule changes addressed concerns that high-cost loans were "packed" with credit life insurance or other similar products that increased the loan's cost without commensurate benefit to consumers.

The Board also increased protections for consumers under discretionary rulemaking authority in HOEPA that authorizes the Board to prohibit unfair or deceptive practices or practices designed to evade HOEPA for all mortgage loans. Specifically, in 2001 the Board revised the HOEPA rules to prohibit a HOEPA lender from refinancing one of its own loans with another HOEPA loan ("flipping") within the first year, unless the new loan is "in the borrower's interest." We also adopted a prohibition on "demand notes" for high-cost, closed-end mortgages to mirror the similar statutory prohibition in TILA for home equity lines of credit. In addition, the Board prohibited creditors from evading HOEPA's requirements for closed-end loans by

documenting the transaction as an "open-end" line of credit when it does not qualify, because there is no expectation of repeat transactions under a reusable line.

These three revisions to HOEPA are cases where the Board determined that it could write "bright-line" rules defining an unfair and prohibited practice. However, because a determination of unfairness or deception depends heavily on the facts of an individual case, the Board has not issued other rules under this provision. The Board has undertaken a major review of Regulation Z, the implementing regulation for the Truth in Lending Act, of which HOEPA is a part. During this review, the Board will determine if there are opportunities to further utilize this authority in an appropriate manner.

HMDA Loan Price Information and Expanded Coverage of Nondepository Lenders. The Home Mortgage Disclosure Act (HMDA) requires most mortgage lenders in metropolitan areas to collect data about their housing-related lending activity, report the data annually, and make the data publicly available. Congress authorized the Federal Reserve Board to issue regulations implementing HMDA.

In 2002, to bring greater transparency to the subprime mortgage market, the Board made two changes to the HMDA rules: adding a requirement to report loan price information for certain higher priced loans, and extending reporting responsibilities to more independent state-regulated mortgage companies. These changes first took effect for HMDA data collected in 2004 and disclosed in 2005.

Based on 2004 and 2005 HMDA data, independent mortgage companies originated slightly more than half of subprime loans. The new loan price information and the expanded coverage of nondepositories have increased our ability to detect potential problems in the

subprime market and to conduct reviews of banks' fair lending practices. It has also facilitated the states' ability to oversee independent state-regulated mortgage companies.

Guidance on Unfair or Deceptive Acts or Practices. In March 2004, the Board and the FDIC issued guidance on Unfair or Deceptive Acts or Practices (UDAP) to state-chartered banks. The guidance outlines the legal standards the agencies use in carrying out their responsibilities for enforcing the Federal Trade Commission Act's prohibition of unfair or deceptive acts or practices. The guidance is based on long-standing Federal Trade Commission policy statements that have been applied by courts. The guidance outlines strategies for banks to use to avoid engaging in unfair or deceptive acts or practices, to minimize their own risks and to protect consumers. Among other things, the guidance focuses on credit advertising and solicitations, loan servicing, and managing and monitoring creditors' employees and third-party service providers.

2006 Guidance on Nontraditional Mortgage Product Risks. In 2005, the Federal Reserve and the other federal agencies observed that lenders were increasingly combining nontraditional or "exotic" mortgage loans, which defer repayment of principal and sometimes interest, with the risk-layering practices that I talked about earlier. Of particular concern were the lack of principal amortization and the potential for negative amortization in these products. Moreover, the easing of underwriting standards and the marketing of these products to a wider spectrum of borrowers, including those purchasing rental properties, held the potential to create larger risks. The guidance also addresses the concern that borrowers were obtaining these loans without understanding their risks as well as their benefits.

To address those concerns, the Federal Reserve and the other banking agencies issued guidance on nontraditional mortgage products last September. The *Interagency Guidance on*

Nontraditional Mortgage Product Risks highlights sound underwriting procedures, portfolio risk management, and consumer protection practices that institutions should follow to prudently originate and manage nontraditional mortgage loans. A major aspect of this guidance is the recommendation that a lender's analysis of repayment capacity should include an evaluation of the borrower's ability to repay debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. The guidance also reminds institutions that they should clearly communicate the risks and features of these products to consumers in a timely manner, before consumers have applied for a loan.

To complement the guidance on consumer protection, the agencies issued for comment proposed illustrations that show how institutions might explain the risks and terms to consumers in a clear and timely manner. The agencies are reviewing the comment letters to develop final illustrations.

Proposed Guidance on Subprime Mortgage Lending. Earlier this month, the agencies proposed the *Interagency Statement on Subprime Mortgage Lending* for public comment. This proposal specifies the same qualification standard as the nontraditional mortgage guidance and emphasizes the added dimension of risk when these products are combined with other features such as simultaneous second lien loans in lieu of a down payment, or the use of underwriting that involves little or no documentation of income or assets. However, unlike the nontraditional mortgage guidance, which primarily targeted prime loans with the potential for negative amortization, the proposed guidance is primarily directed to loans targeted to subprime borrowers and covers fully amortizing loans. The proposed subprime guidance also differs from earlier guidance in that it highlights the need for lenders to underwrite based not only on principal and interest but also on taxes and insurance. And, the proposed guidance provides that

lenders should inform consumers of the need to budget for taxes and insurance if escrows are not required.

The proposed subprime guidance would apply to all depository institutions, their subsidiaries, and non-depository affiliates, but not to state-regulated independent mortgage companies. These mortgage companies originated slightly more than half of subprime loans, according to 2004 and 2005 HMDA data. To protect borrowers in the broader subprime market that is outside our purview, and to ensure a "level playing field" for depository institutions and independent mortgage companies, we coordinated the development of the proposed guidance with the Conference of State Bank Supervisors (CSBS). CSBS has committed to making every effort to encourage the states to consider proposing this guidance for state-regulated lenders.

Public comments are due on the proposed guidance by May 7, 2007. The agencies are particularly interested in comments on whether the guidance would unduly restrict the ability of existing subprime borrowers to refinance their loans and avoid payment shock.

The Board's Plans to Make Consumer Disclosures More Effective

The Federal Reserve has responsibility for the regulations associated with TILA and its required disclosures. While consumer disclosures alone cannot solve the problems that lead to foreclosures, disclosures help consumers to understand the terms and features of various mortgage products before entering into a long-term financial obligation. To that end, the Federal Reserve Board has begun a comprehensive review of Regulation Z, which implements TILA. Currently, the Federal Reserve is addressing credit card disclosures and expects to address mortgage cost disclosures in the next phase of the review.

I would like to tell you what we have already done to prepare for the next phase of the TILA review, some intermediate steps we have taken to improve consumer information, and our plans for the review itself.

The Federal Reserve's Hearings on Home-Equity Lending: Building Sustainable Homeownership Through Responsible Lending and Informed Consumer Choice

During the summer of 2006, the Federal Reserve held public hearings addressing sustainable homeownership in four cities. One of the principal purposes of the hearings was to gather information to inform the Board's review of Regulation Z disclosures, including disclosures for ARMs and for nontraditional mortgage products such as payment option ARMs. A significant portion of the hearings was devoted to discussing ARMs and, in particular, whether consumers receive adequate information about the features and risks associated with mortgages. The hearings explored consumer behavior in shopping for mortgage loans and included discussions about the challenges involved in designing more effective and informative disclosures.

At the hearings, lenders cited the strong performance of products such as payment option ARMs. Industry representatives believed that when loans are prudently underwritten, consumers are able to benefit from the flexibility these products provide without being at risk of default.

On the other hand, consumer advocates and state officials testified that aggressive marketing and the complexity of ARMs put borrowers at additional risk of obtaining mortgages that they do not understand and might not be able to afford. Consumer advocates were particularly concerned about mortgage brokers and lenders "push-marketing" nontraditional mortgages and ARMs to low-income consumers and borrowers who live on fixed-incomes, without adequate regard for whether the products are appropriate for their particular circumstances. They expressed concern about marketing that focuses too heavily on low initial

payments that are based on discounted rates or "minimum payment options" that quickly expire. While they supported enhanced disclosures to inform borrowers about worst-case payment scenarios, they questioned whether disclosures alone can protect consumers because the products are so complex. Accordingly, consumer advocates testified in favor of adopting legal standards that would hold brokers and lenders liable for making unaffordable mortgage loans.

As I indicated, the Board plans to begin a review of the mortgage cost disclosures this year. However, because rulemakings take time, the Board took more immediate steps to improve the information consumers receive about ARMs and other alternative mortgages. These steps included revising the CHARM booklet and publishing a consumer education brochure.

The CHARM Booklet

The Board and the Office of Thrift Supervision recently revised the Consumer Handbook on Adjustable Rate Mortgages (CHARM booklet) to include additional information about nontraditional mortgage products, including "hybrid" ARMs that include an initial fixed-rate period. The CHARM booklet is an effective means of delivering to consumers information about adjustable rate mortgage products because creditors are required to provide a copy of the booklet to each consumer when an application for an ARM is provided.

The Board's Role in Consumer Education

The Board has taken other steps to increase consumer awareness of the risks of nontraditional mortgage loans. We provide consumer information, both in print and on the web, on adjustable rate, interest-only, and payment option mortgages. We published a consumer education brochure titled: Interest-Only Mortgage Payments and Payment-Option ARMs--Are They for You? The brochure is designed to assist consumers who are shopping for a mortgage loan.

The Board's Review of Mortgage Disclosures under Regulation Z

To ensure that consumers get timely information in a form that is readily understandable, the Board will study alternatives for improving both the content and format of disclosures, including revising the model forms published by the Board. As a general matter, in crafting regulations, the Board seeks to gather as much information as possible by conducting outreach to the industry, consumer interest groups, consumers, regulators, and other interested parties. We use research and survey data, consumer focus groups, and consumer testing to learn how consumers use and process information about financial services. After regulatory proposals have been published, we obtain input through the public comment process. In addition, we obtain input from the Board's Consumer Advisory Council, comprised of representatives from consumer and community organizations, financial institutions, industry trade groups, academics, and state and local officials from across the country. And sometimes we hold public meetings such as the home-equity hearings that I mentioned before.

In considering how to improve disclosures for ARMs and other alternative mortgage products under TILA, the Board will conduct extensive consumer testing to determine what information is most important to consumers, when that information is most useful, what wording and formats work best, and how disclosures can be simplified, prioritized, and organized to reduce complexity and information overload. To that end, the Board will use design consultants to assist in developing model disclosures that will be effective in communicating information to consumers. This process will also assist the Board in developing model disclosure forms. Based on this review and testing, the Board will revise Regulation Z within the existing framework of TILA. If the Board determines that useful changes to the closed-end disclosures are best accomplished through legislation, the Board will inform the Congress.

Community Affairs and Foreclosure Prevention Initiatives

We sought testimony at our home equity hearings last year on what works to help prevent troubled borrowers to avoid foreclosure. Industry and consumer advocates who testified agreed that the greatest barrier to working with troubled borrowers is in simply making contact with them. These witnesses told us that lenders can reach troubled borrowers through trusted community advocates, and that local partnerships between community groups and lenders can help reduce the number of homes lost to foreclosure. One national nonprofit homeownership organization, NeighborWorks America® (NeighborWorks), has been working tirelessly to forge local and regional partnerships dedicated to homeownership preservation in recent years to assist financially troubled borrowers. The benefit of such outlets is illustrated in an informal survey of borrowers in foreclosure conducted by a NeighborWorks affiliate in Chicago that found that 50 percent of borrowers in foreclosures never sought help or advice about the foreclosure from their lender, primarily because these borrowers believe their lender cannot or will not do anything to help them. The Federal Reserve Board actively supports NeighborWorks in both its national efforts and regional initiatives. A Federal Reserve governor serves on the NeighborWorks board of directors, offering strategic direction and input on the corporation's national programs. Board staff also serves on a NeighborWorks' advisory council, providing technical assistance on the development of national homeownership counseling and education standards, with an emphasis on post-homebuyer counseling programs. Our efforts are intended to provide consistency in the education on the responsibilities and financial management skills necessary for successful homeownership. In addition, the Federal Reserve Banks throughout the country work with regional affiliates of NeighborWorks, as I will discuss later.

This information underscores the value of local and regional engagement in addressing mortgage challenges, which stem from many factors and dynamics in local markets. Given this, the decentralized nature of the Federal Reserve System, and in particular, its Community Affairs Offices, have enabled the Federal Reserve Banks to respond to concerns of mortgage delinquency and foreclosure in ways that are directly responsive to the needs in their markets. Various initiatives have worked to increase understanding of the issues surrounding troubled borrowers and identify strategies to respond to their needs. Other efforts have sought to improve data and research on foreclosure to help illuminate issues and communities of concern. I will offer a few examples of the work of the Federal Reserve Community Affairs Offices (CAOs), and I have provided a more complete list of such initiatives as an addendum to my testimony.

The Atlanta Federal Reserve District, which includes several southern states--Georgia, Florida, Louisiana, in particular--that are experiencing an increasing number of foreclosures, is part of a state-wide foreclosure prevention taskforce, which is undertaking a series of activities around fraud prevention, consumer education, and training for counseling agencies. This initiative began in 2005, when foreclosures spiked in Atlanta, with the Federal Reserve Bank partnering with the district office of NeighborWorks America® and the Georgia Department of Community Affairs. The effort has worked to provide foreclosure prevention training to partnering counseling agencies, to promote the use of homeownership preservation hotlines, and to increase consumer education and awareness of foreclosure prevention resources. In the Gulf Coast, the Atlanta Federal Reserve Bank has also supported outreach to consumers, including training for counselors and promotion of a hotline and workout arrangements, with a focus on foreclosure prevention.

Similarly, the Federal Reserve Bank of Cleveland's Community Affairs Office has responded to the widespread problem of mortgage foreclosures in its District, especially in Ohio where foreclosure rates are among the highest in the country. To respond to the issue, the Cleveland Federal Reserve Bank's CAO is working with government, financial institutions and community based organizations in assessing and addressing regional foreclosure issues. It hosted an Ohio Foreclosure Summit in 2005, which led to the introduction of the NeighborWorks America® foreclosure hotline in Ohio, and addressed issues of financial education, predatory lending, policy, regulation, and enforcement. A similar event was held in 2006 to continue to engage community, industry and government representatives in discussing issues surrounding foreclosure.

Other Federal Reserve Banks have worked to address challenges associated with access to data on mortgage delinquency and foreclosure in their Districts. The Kansas City Federal Reserve Bank has been tracking and posting foreclosure and delinquency data from the Mortgage Bankers Association for each of the states within its District to help identify trends and areas of concern. Ongoing research efforts will seek to develop a literature review around the possible causes of foreclosure, analyze foreclosure trends by mortgage types, and assess the potential impact in the Kansas City Federal Reserve District. The Boston Federal Reserve Bank recently published a paper on foreclosure trends in Massachusetts. The CAO at the Federal Reserve Bank of Minneapolis has worked to acquire local data on foreclosures and share it with audiences throughout the Twin Cities. In addition, forthcoming research undertaken by staff analyzes foreclosure data in the Twin Cities to identify ways of predicting potential foreclosures, which may be useful as a tool for targeting foreclosure prevention efforts. These results will be

presented at our Community Affairs System Research Conference to be hosted in Washington later this week.

Conclusion

Undoubtedly, the impact of mortgage delinquency and foreclosure on consumers and communities is one of great concern to the Federal Reserve, and we have worked to respond to the issue at both the national and regional levels. One of the many challenges that we confront in this environment is to address concerns regarding mortgage lending practices while preserving the flexibility necessary to allow lenders to help troubled borrowers by employing various foreclosure prevention strategies, including debt restructuring and refinance. Certainly, we all recognize the importance of preserving the record rate of homeownership, which is to the benefit of both consumers and the economy. And, a robust and disciplined subprime market is vital to ensuring continued progress in broad access to credit and homeownership. We look forward to working with the other federal banking and thrift agencies, and to coordinating those efforts with the states through the Conference of State Bank Supervisors, in ensuring that subprime borrowers can obtain mortgage loans that they can afford to repay. We have much work ahead of us, as there is no one sure and easy "fix" for delinquencies and foreclosures. We will continue to pursue opportunities to help borrowers and to preserve access to responsible lending.

Attachment to Sandra Braunstein's Statement
The Board of Governors of the Federal Reserve System
Timeline of Major Events and Supervisory Responses
Related to Real Estate, Nontraditional and Subprime Lending
March 27, 2007

- **1990 and 1994** – Poor real estate appraisal practices were identified as a contributing factor to real estate lending problems at failed institutions in the late 1980s and early 1990s. Pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the agencies adopted real estate appraisal regulations to establish appropriate standards for regulated institutions' real estate appraisal practices. In 1994, the agencies amended their appraisal regulations and issued Interagency Appraisal and Evaluation Guidelines to further promote sound appraisal practices.

- **1993** – In response to poor real estate lending practices in the late 1980s and early 1990s that led to thrift and bank failures, and the FDIC Improvement Act of 1991, the agencies adopted regulations and guidelines on real estate lending standards for commercial and residential lending. These guidelines impose supervisory loan-to-value (LTV) limits and capital limitations on high LTV loans.

- **1998 through 2002** – Five institutions closed due to problems related to subprime lending, including poor underwriting, fraud, and valuation of securitization and residual interests.
  - July 1998 - Bestbank
  - September 1999 - Keystone
  - November 1999 - Pacific Thrift and Loan
  - July 2001 - Superior
  - February 2002 - Nextbank

- **1999** – The agencies identified problems related to the risk management practices and valuation of securitization and residual interests at federally regulated subprime lenders. In December 1999, the agencies issued the Interagency Guidance On Asset Securitization Activities that describes the proper valuation of residual interests and highlights situations where such interest should be assigned no value.

- **1999** – Problems were observed at both regulated and nonregulated subprime lenders, resulting in the bankruptcy of several nonregulated lenders. In March 1999, the agencies issued the Interagency Guidance on Subprime Lending to address concerns with mono-line subprime lending institutions.

  1999 – In October 1999, the agencies issued the Interagency Guidance on High Loan-to-Value (LTV) Residential Real Estate Lending to remind institutions that risks are higher in residential mortgages when the LTV ratio exceeds 90 percent and that institutions' risk management practices need to address these risks.

  2001 – In January 2001, the agencies issued the Expanded Guidance for Subprime Lending Programs. The issuance was in large part in response to the increasing number of mono-line

subprime lending institutions, particularly credit card and residential mortgage lending. The guidance addresses a number of concerns related to the subprime lending business model and inappropriate risk management practices and underwriting standards.

2001 – As a result of concerns with predatory lending in the subprime mortgage market, the Federal Reserve revised the rules implementing the Home Ownership and Equity Protection Act (HOEPA) to extend HOEPA's protections to more high-cost loans and to strengthen HOEPA's prohibitions and restrictions, including a requirement that lenders generally document and verify a consumer's ability to repay a high-cost mortgage loan.

- **2002** – The Federal Reserve expanded the data collection and disclosure rules under the Home Mortgage Disclosure Act (HMDA) to increase transparency in the subprime mortgage market. New data elements were added on loan pricing for certain higher priced loans, which helps to facilitate the federal banking and thrift agencies' ability to identify potential problems in the subprime market. The Federal Reserve also expanded the share of nondepository state-regulated mortgage companies that must report HMDA data, which has provided a more complete picture of the mortgage market, including the subprime mortgage market.

- **2003** – The agencies observed weaknesses in regulated institutions' appraisal practices and issued in October the Interagency Guidance on Independent Appraisal and Evaluation Functions. The statement reinforces the importance of appraiser independence from the loan origination and credit decision process to ensure that valuations are fairly and appropriately determined.

- **2003 to 2006** - The Federal Reserve issued three formal enforcement actions and three informal actions, which involve mortgage lending issues, including subprime mortgage lending. Formal enforcement actions included:
  - Citigroup Inc. and CitiFinancial Credit Company: Cease & Desist Order 5/ 27/04
  - Doral Financial Corporation - Cease & Desist Order – 3/16/06
  - R&G Financial Corporation - Cease & Desist Order – 3/16/06

- **2004** – In March 2004, the Federal Reserve and the FDIC issued Interagency Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks. This guidance describes standards that the agencies will apply to determine when acts or practices by state-chartered banks are unfair or deceptive. Such practices are illegal under section five of the Federal Trade Commission Act.

- **2005** – In February 2005, the agencies under the auspices of the Federal Financial Institutions Examination Council issued interagency guidance on the Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties to assist the banking industry in detecting, investigating, and deterring third party mortgage fraud. The term "third party" refers to the parties necessary to execute a residential mortgage other than a financial institution or a legitimate borrower. Third parties include mortgage brokers, real estate appraisers, and settlement agents.

- **2005** – As a result of the 2003 interagency appraisal independence guidance, many institutions started to review their appraisal practices and asked for additional guidance on appropriate practices. In March the agencies issued a follow-up document of questions and answers to promote sound appraisal and collateral valuation practices.

  2005 – In response to supervisory concerns that regulated institutions' risk management practices were not keeping pace with the rapid growth and changing risk profile of their home equity loan portfolios, the agencies issued in May the Interagency Credit Risk Management Guidance for Home Equity Lending.

- **2005 to 2006** – The Federal Reserve conducted supervisory reviews of mortgage lending, including subprime lending activity, at large banking institutions with significant mortgage lending activity. The focus of these reviews was an assessment of the adequacy of the institutions' credit risk management practices, including lending policies, underwriting standards, appraisal practices, portfolio limits and performance, economic capital, credit stress testing, management information systems, and controls over third party originations.

- **2004 to 2005** – The agencies observed a rapid growth of mortgage products that allow for the deferral of principal, and sometimes interest, (interest-only loans and payment option ARMs) that contain the potential for substantial payment shock when the loans begin to fully amortize. In 2004 and 2005, the Federal Reserve and the other agencies reviewed the nontraditional mortgage lending activity and risk management practices at selected major regulated institutions. During this time, the Federal Reserve staff met with various industry and consumer groups to discuss the trends and practices in the nontraditional mortgage markets. In December 2005, the agencies issued the proposed Interagency Guidance on Nontraditional Mortgage Products in December 2005.

- **2006** – In October 2006, the agencies issued the Interagency Guidance on Nontraditional Mortgage Product Risks. The guidance addresses the need for an institution to have appropriate risk management practices and underwriting standards, including an assessment of a borrower's ability to repay the loan at the fully indexed rate, assuming a fully amortizing repayment schedule, including any balances added through negative amortization. The guidance details recommended practices for lenders' consumer disclosures so that a borrower receives clear, balanced and timely information.

- **2006** – In October 2006, the agencies issued two additional documents related to the nontraditional mortgage guidance: (1) Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products and (2) an addendum to the May 2005 Interagency Credit Risk Management Guidance for Home Equity Lending.

- **Current** – In March 2007, the agencies issued for public comment the Proposed Statement on Subprime Mortgage Lending in which the agencies discuss the risk management, underwriting standards, and consumer disclosure practices for a regulated institution's subprime mortgage lending activity.

Overview of Foreclosure Prevention Initiatives by Federal Reserve System's Community Affairs Offices

The Federal Reserve System's Community Affairs Offices have been engaged in a variety of activities to respond to the needs of low- and moderate-income communities experiencing an increase in foreclosures. Some activities by Reserve Banks are building their understanding of the problem and its manifestation in each District. Others are working with community stakeholders to advance understanding of foreclosure prevention strategies, several of which are in conjunction with the NeighborWorks America® (http://www.nw.org/network/home.aspa), a national nonprofit housing development network. This listing highlights various initiatives at the Federal Reserve Banks in this area.

Atlanta

The Atlanta District includes several of the southern states--Georgia, Florida, Louisiana in particular--where there are an increasing number of foreclosures. The ongoing challenges of rebuilding the Gulf Coast, when viewed in conjunction with the distribution of poor credit scores in southern states as detailed by the Brookings Institution (http://www.brookings.edu/metro/pubs/20060501_creditscores.pdf) leads many to expect continued increases in foreclosures and defaults in the Sixth District. In Georgia, the Community Affairs Office is part of a state-wide foreclosure prevention taskforce, which is undertaking a series of activities around fraud prevention, consumer education, and training for counseling agencies. In the Gulf Coast, the Reserve Bank has supported outreach to consumers, including training for counselors and promotion of a hotline and workout arrangements, with a focus on foreclosure prevention.

Boston

The Community Affairs Office has published a paper on foreclosure issues and trends in Massachusetts, including data on foreclosure patterns in the state. In addition, it has developed a consumer education brochure on mortgages, "Know Before You Go... To Get a Mortgage A Guide to Mortgage Products and a Glossary of Lending Terms (http://www.bos.frb.org/consumer/knowbeforeyougo/mortgage/index.htm)," to provide general mortgage information to consumers and to shed some light on the risks associated with today's more complex mortgage offerings.

Chicago

In the Chicago Federal Reserve District, the Community Affairs Office hosted a symposium in January to highlight non-traditional mortgage products and risks. In 2006, it published a paper on foreclosure alternatives and an article discussing the benefits and risks of nontraditional mortgage products.

Cleveland

The Federal Reserve Bank of Cleveland reports a widespread problem with mortgage foreclosures in weaker housing markets within the 4th District. Ohio also recently reported the highest rate of foreclosures in the nation. To address the issue, the Bank is serving as a convener of government, financial institutions and community based organizations in assessing and addressing regional foreclosure issues. Among the events Cleveland has hosted was an Ohio Foreclosure Summit in 2005 (http://www.clevelandfed.org/CommAffairs/Past_2005.cfm), which led to the introduction of the NeighborWorks 1-800 hotline in Ohio, and addressed issues

of financial education, predatory lending, policy, regulation, and enforcement. In addition, the Bank participated in a 2006 Ohio Foreclosure Summit. Both summits included community, industry and government representatives.

Last year, the Cleveland Federal Reserve Bank participated in the launch of the official Financial Partnership of the Miami Valley Website and Directory, www.fepmv.org. Community-based organizations, non-profit organizations, financial and academic institutions partnered to produce this directory in 2005. The website and directory are resource guides to assist residents and community-based organizations in finding professional service providers that can provide assistance with basic money management and help in resolving difficult financial situations such as foreclosure.

The Cleveland Federal Reserve will soon release a research paper examining the data availability and gaps that exist in accurately tracking foreclosures within the district. The report explains the challenges that exist in assessing the scope and scale of the issue and barriers to address it due to lack of information.

Dallas

Staff of the Community Affairs Office in Dallas participates in homeownership coalitions composed of financial institutions, non-profit organizations and local government representatives. In Dallas, the coalition has been meeting since 2004. They meet regularly to share information about the scope of the problem, and in Dallas have promoted a toll-free number sponsored by the GMAC Mortgage and Homeownership Preservation Foundation to link consumers to resources. A similar coalition has been recently organized in Houston.

The Federal Reserve Bank of Dallas is also organizing a foreclosure summit scheduled for June in partnership with Fannie Mae, Freddie Mac, National Association of Homebuilders, and the Council of Governments to convene stakeholders from throughout the state to help develop a better understanding of the problems and potential responses to delinquency and foreclosure.

Kansas City

The Kansas City Reserve Bank has been tracking and posting foreclosure and delinquency data from the Mortgage Bankers Association by each state within its District. Ongoing research is taking place to assess similarities or discrepancies in the data. In addition, a forthcoming paper will include a literature review around the possible causes of foreclosure, an analysis of foreclosure trends by mortgage types, and an assessment of the potential impact to the Tenth Federal Reserve District.

Minneapolis

The Community Affairs Office at the Minneapolis Federal Reserve Bank has worked to develop local data on foreclosures by purchasing sheriff's data and sharing it with audiences throughout the Twin Cities, including a coalition to increase minority homeownership which has ongoing support from Community Affairs. Researchers have authored a paper analyzing foreclosure data in the Twin Cities to identify ways of predicting potential foreclosures, a potentially useful tool for targeting foreclosure prevention efforts. The research also makes recommendations regarding the availability of data on default and foreclosure. Staff also published an article in 2006 on the availability of foreclosure data, and a paper on various state approaches to regulation of mortgage brokers will soon be posted to its website.

New York

The Federal Reserve Bank of New York is focused on using data to inform its targeted geographies (Albany, New York City, Rochester, Puerto Rico) for information sharing, highlighting of best practices, and educating both the private and non-profit sectors on the foreclosure challenges and prevention. Toward this end, the Community Affairs Office sponsored two forums in November 2006. The first meeting convened mortgage servicers and lenders to discuss foreclosure prevention best practices and strategies, resulting in increased involvement on the part of many lenders, funding for anti-foreclosure programs by foundations, and the establishment of special 1-800 numbers or designated contacts to non-profit housing counselors. The second meeting aimed to educate non-profits about how the mortgage securitization process works, which resulted in providing some housing counselors a common language to facilitate a better understanding of why some work-out strategies are more feasible than others.

Philadelphia

The Federal Reserve Bank of Philadelphia published a technical brief on HEMAP (http://www.phfa.org/consumers/homeowners/hemap.aspx), a state-funded program in Pennsylvania that assists homeowners who are in default, but who can be expected to "recover" in a reasonable period of time. The Community Affairs Office's outreach has focused on increasing public awareness on the need to understand mortgage terms. The program developed a video on debt, which includes a focus on being a knowledgeable mortgagee.

San Francisco

The Federal Reserve Bank of San Francisco's Community Affairs Office has identified concentrations of subprime lending, using data from a recent report from the Center for Responsible Lending (http://www.responsiblelending.org/) that identifies concentrations in California's Central Valley (Fresno, Bakersfield, etc.) and in Nevada, primarily Las Vegas.

The Community Affairs Office is currently planning a series of local roundtables that are bringing together local stakeholders--financial institutions, counseling organizations, local governments and community development practitioners, to identify in their local markets steps to: i) mitigate foreclosures, ii) implement foreclosure prevention strategies, and iii) mitigate the effects on neighborhoods where foreclosures are concentrating. Those roundtables are currently scheduled for San Francisco, Los Angeles, Phoenix, Las Vegas and Nevada. In each city, the goal is to seed a working group which will be able to collectively develop an action plan or strategy around issues such as increasing the capacity of local counselors, creation of rescue funds, or providing refinance opportunities.

TESTIMONY OF

STEVEN L. ANTONAKES

MASSACHUSETTS COMMISSIONER OF BANKS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

"SUBPRIME AND PREDATORY LENDING: NEW REGULATORY GUIDANCE, CURRENT MARKET CONDITIONS, AND EFFECTS ON REGULATED FINANCIAL INSTITUTIONS"

Before the

FINANCIAL SERVICES COMMITTEE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

UNITED STATES HOUSE OF REPRESENTATIVES

March 27, 2007, 10:00 a.m.

Room 2128 Rayburn House Office Building

Introduction

Good morning, Chairman Maloney, Ranking Member Gillmor, and distinguished members of the Subcommittee. My name is Steven L. Antonakes, and I serve as the Commissioner of Banks for the Commonwealth of Massachusetts. I am also the Chairman of the State Liaison Committee (SLC), making me the newest voting member of the Federal Financial Institutions Examination Council (FFIEC).[1] It is my pleasure to testify today on behalf of the Conference of State Bank Supervisors (CSBS).

CSBS is the professional association of state officials responsible for chartering, supervising, and regulating the nation's 6,206 state-chartered commercial and savings banks, and 400 state-licensed foreign banking offices nationwide. For more than a century, CSBS has given state bank supervisors a national forum to coordinate, communicate, advocate and educate on behalf of state bank regulation.

In addition to regulating banks, 49 states plus the District of Columbia currently provide regulatory oversight of the residential mortgage industry. The one exception is Alaska, which is currently working toward a legislative solution. Under state jurisdiction are more than 90,000 mortgage companies with 63,000 branches and 280,000 loan officers and other professionals.[2] In recent years, the states have been working diligently to improve supervision of the residential mortgage industry. Despite these ongoing efforts, there are numerous problems in the mortgage lending system significantly impacting consumers in this country as evidenced by the need for this Committee's hearing today.

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[1] The Federal Financial Institutions Examination Council (FFIEC) is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) and to make recommendations to promote uniformity in the supervision of financial institutions. The FFIEC website is http://www.ffiec.gov.

[2] The above numbers do not include the State of California's Department of Real Estate's approximately 480,000 licensed real estate agents who could also function as a mortgage broker under their license.

The United States did not arrive at the current disarray in the residential mortgage market overnight and no single party is fully responsible for our current situation. CSBS believes the rapid and drastic changes in the industry created an environment of negligence in lending practices and increased borrower confusion. States stepped in to act as the primary regulator in this new industry, but have been, and continue to be, hampered by federal preemption. State regulators do not eschew responsibility, but Congress, federal regulatory agencies, mortgage lenders and brokers, insured depository institutions, and borrowers must all accept a measure of responsibility for aiding in the creation of our current residential mortgage marketplace.

Madam Chair, in my testimony I will address the recent evolution of the residential mortgage market. I will also address several actions being taken by state regulators to supervise the residential mortgage industry, including the development of a national licensing system, parallel guidance on nontraditional mortgage products, and the intent to develop a parallel statement on subprime mortgage lending, as well as how these and other state efforts have been impeded by preemption. I will also describe a few actions Congress can take to drastically improve the mortgage market.

Evolution of the Residential Mortgage Industry

The changes in the residential mortgage industry over the past twenty years have been dramatic and far-reaching. The mortgage market now has a bigger impact on the economy as a whole, has ushered in new players, and has created an explosion in product choices.

The volume of loan originations has increased drastically over the past two decades. This increase in loan volume was facilitated in part by advances in technology,

such as the automated underwriting systems, the increase of mortgage products available to the consumer, the evolution of the subprime market, and an expansion of the holders in the secondary market for mortgage securities, including international investors, hedge funds, and private equity funds.

Twenty years ago, federal and state regulated savings and loans originated most of the residential mortgages. Federal government-sponsored enterprises (GSEs) or agencies such as Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA) held a significant percentage of the market share and effectively set standards for the entire industry. Subsequent to the savings and loan crisis in the 1980s, the origination of mortgage loans shifted primarily to mortgage brokers and mortgage lenders.

Mortgage brokers and lenders are not a product of state government. However, state regulation, supervision and enforcement of the mortgage industry are creations of state government. Initially, these providers were unlicensed. But as the market grew, the number of players increased, and practices evolved, the states began requiring registration and licensing of providers. The state regulatory agencies are responding to the needs of the residential mortgage industry and mortgage consumers.

I am aware that some industry observers have referred to our current situation as a "broker problem." Certainly, the marketing and sales practices of mortgage lenders and brokers, as well as increased accountability, need to be addressed. The coordinated state and federal guidance begin to address this situation. However, a mortgage broker is only as good as his or her ability to obtain funding for a loan. To that regard, the majority of loans now originated by mortgage brokers and lenders at the local level are in fact financed by Wall Street firms that operate at a global level.

The mortgage revolution has brought with it a number of good things: a vast flow of liquidity into the mortgage market, increased availability of mortgage credit, and higher rates of homeownership. It has also brought moral hazard, as the allocation of risk of a mortgage loan default became dispersed through complex contractual arrangements that began with the local mortgage broker, and ultimately ended with a Wall Street investor. This dispersal of risk created opportunities and incentives for some actors to engage in weak underwriting or fraud. As a result, there have been significant increases in fraud and foreclosures.

CSBS and state regulators believe this increase in product choice and loan characteristics are ultimately beneficial to consumers. An expanding variety of products and loan options increase the likelihood that a consumer will purchase a loan that best fits their unique financial situation. CSBS and state regulators are concerned, however, that underwriting standards have decreased nationwide while consumer protection provisions seem to be inadequate and our state efforts to improve them have been preempted. Additionally, with increasingly complex products, federal attempts at disclosure seem more geared toward protecting lender liability than providing clarity for consumers. The pace of product innovation has exceeded the pace of consumer education and understanding. Our concern is that consumers do not fully understand the characteristics and risks of the products they are purchasing and that some brokers and lenders have ignored the borrower's ability to repay the loan. Borrowers should be educated and share the responsibility to realize that their mortgage obligation is more than a monthly payment. Affordability means looking at the total cost of homeownership.

Federal Preemption Issues

Despite all the actions taken by the states on an individual basis and on a coordinated nation-wide basis, CSBS recognizes state supervision of the mortgage industry is still evolving. But we are frustrated in our efforts to protect consumers by the preemption of state consumer protection laws by federal statutes and federal regulatory agencies. The decision was made to preempt state laws in favor of developing laws that offer advantages to the financial services industry. Federal policies and procedures should support, not hinder the role of state supervisors. State legislatures have the right to expect the laws they passed to be followed by companies operating in their state. Preemption must be used for the benefit of both business and consumers. All too often, it seems, preemption benefits tip the scales too far in favor of businesses, leaving consumers at a disadvantage.

The OCC and the OTS have essentially undermined the states as the laboratory for innovation in the protection of their consumers. With the vast majority of assets under supervision falling under the federal charters and the expansion of preemption to subsidiaries, deemed "divisions" of the bank, and agents of thrifts, states have been neutralized in their response to predatory practices seen in their states. States have tried things as simple as prohibiting prepayment penalties on troublesome loans to solutions as innovative as providing for assignee liability for investment bankers that buy and securitize these subprime mortgages. Many have been blocked at the state level through claims of unfair treatment of state lenders or through threats of a legislatively generated credit crunch in the states. The OCC and the OTS have tried to make it crystal clear through their regulations that any state law that conditions what their federally-chartered institutions, subsidiaries of those institutions, or even agents of those institutions can do are

preempted and the states have no ability to enforce state laws against those institutions. State supervised lenders cry foul when the state legislators try and implement new consumer protections because their federal counterparts do not have to comply.

State Regulatory Responses

For years, the state banking system has been the laboratory for innovation and for developing the best practices in products and services and consumer protection. The states are best positioned to serve this role because it is at the state level that both businesses and consumers have proximity, access, and accountability from their regulatory agencies.

Despite the obstacles of preemption, as the mortgage industry has rapidly evolved, the states have played a more active role in its regulation and supervision. It is worth noting that the residential mortgage industry as we know it is relatively young. Therefore, state supervision of the industry is also relatively new. Conversely, state bank supervision in the United States has been in existence since the late 1700s. The first bank chartered in my home state of Massachusetts, the Bank of Massachusetts, was chartered in 1784. The charter was signed by Governor John Hancock and Senate President Sam Adams. Obviously, state bank supervision has had centuries to evolve and improve. State mortgage supervision grows and improves each day.

The actions taken by the states in response to the evolving mortgage market have focused on protecting consumers through development of licensing and supervision of mortgage brokers and lenders, legislation, and enforcement of consumer protection laws. Each day state regulators take enforcement actions against mortgage lenders and brokers for abusive lending. I have attached, as Exhibit A, a few illustrations of the efforts by state mortgage regulators to supervise and regulate this industry.

Recognizing, however, that many mortgage lenders and brokers operate on a multi-state or nationwide basis, the states, through CSBS and the American Association of Residential Mortgage Regulators (AARMR), are developing cooperative initiatives and tools to more effectively regulate the marketplace.

CSBS-AARMR National Residential Mortgage Licensing System

On a national scale, CSBS has partnered with AARMR to ensure that consumers are protected from fraudulent practices and receive adequate information regarding mortgage service providers. Over two years ago, CSBS and AARMR embarked on an initiative that will change the world of mortgage supervision. CSBS and AARMR are creating a national mortgage licensing system to improve the efficiency and effectiveness of the U.S. mortgage market, to fight mortgage fraud and predatory lending, to increase accountability among mortgage professionals, and to unify and streamline state licensing processes for lenders and brokers. Scheduled to begin operations on January 1, 2008, this system will create a single record for every state-licensed mortgage company, branch, and individual that will be shared by all participating states. This single record will allow companies and individuals to be tracked across state lines and over any period of time.

Last month, 29 states announced their intent to participate in the system by the end of 2009. CSBS expects several more states to announce their similar intent over the next few months. To my knowledge, no other regulator is developing or even contemplating such a system.

State mortgage regulators began discussing ways to bring more accountability and uniformity into state mortgage licensing beginning in 2003 and 2004. In January 2005

regulators began meeting on a monthly basis to create uniform license applications and began actual development of the national licensing system.

This national licensing system will also provide consumer access to a central repository of licensing and publicly adjudicated enforcement actions. This will allow homebuyers a central place to check on the license status of the mortgage broker or lender they wish to do business with, as well as a way to determine whether a state has taken enforcement action against that company or individual.

In June 2006, CSBS contracted with the National Association of Securities Dealers, Inc. (NASD) to develop this system. The NASD developed and now operates two national systems in conjunction with or for state regulators: the securities industry Central Registration Depository (CRD) ® and the financial planning and investment advisor industry Investment Adviser Registration Depository (IARD) ® system. The NASD brings significant expertise in developing and operating national licensing systems that are subject to state regulations.

Each state will continue to retain its authority to license and supervise, but the new system will eliminate unnecessary duplication and implement consistent standards and requirements across state lines. Additionally, the state agencies will be able to divert resources previously used for processing applications to more supervision and enforcement.

The system will provide immediate and profound benefits to consumers, the industry, and the state supervisory agencies. Consumers will have access to key information about the providers that they trust with the most important financial transactions of their lives. Honest mortgage bankers and brokers will benefit from the creation of a system that drives out fraudulent and incompetent operators, and from having

one central point of contact for submitting and updating license applications. Everyone benefits from a system that makes it easier to identify and punish the small percentage of dishonest operators in the mortgage industry.

Uniform Standards for Testing and Education

Another major initiative where states are leading is in the development of education and testing requirements for mortgage professionals. CSBS and AARMR are spearheading a cooperative project of 23 state regulatory agencies called the Mortgage Industry National Uniform Testing and Educations Standards (MINUTES). This initiative, begun early this year, will establish acceptable uniform standards and streamline the process for licensees to comply with these standards. MINUTES will ensure that licensed mortgage providers are held to the same standards and expectations, regardless of the state in which they make loans. To my knowledge, no federal regulatory agency currently requires specific educational or testing standards for the mortgage professionals it supervises.

CSBS-AARMR Guidance on Nontraditional Mortgage Product Risks

CSBS and AARMR also partnered together to develop guidance on nontraditional mortgage product risks. In October 2006, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) issued final Interagency Guidance on Nontraditional Mortgage Product Risks. The interagency guidance applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations

and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

Recognizing that the interagency guidance is important and useful, but does not apply to those mortgage providers not affiliated with a bank holding company or an insured financial institution, CSBS and AARMR developed parallel guidance. Both CSBS and AARMR strongly support the purpose of the interagency guidance and are committed to promoting uniform application of its underwriting standards and consumer protection provisions for all borrowers. In order to maintain regulatory consistency, the guidance developed by CSBS and AARMR substantially mirrors the interagency guidance, except for the deletion of sections not applicable to non-depository institutions.

Released on November 14, 2006, the CSBS-AARMR guidance has been offered to state regulators to apply to their licensed residential mortgage brokers and lenders. The CSBS-AARMR guidance is intended to hold state-licensed mortgage providers to effectively the same standards as developed by the federal regulators.

As of today, March 27, 2007, 29 states plus the District of Columbia have adopted the guidelines developed by CSBS and AARMR. Ultimately, CSBS expects all 50 states to adopt the guidance in some form.[3] Once fully adopted nationwide, all mortgage lenders and brokers will be held to the same underwriting and consumer protection standards for nontraditional mortgage products.

[3] To track state adoption of the CSBS-AARMR guidance, go to http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/State_Implementation.htm.

Proposed Interagency Statement on Subprime Mortgage Lending

CSBS and AARMR have also offered our strong endorsement of the recently proposed interagency Statement on Subprime Mortgage Lending. In conjunction with the 2006 Interagency Guidance on Nontraditional Mortgage Product Risks and the parallel CSBS-AARMR guidance, the proposed statement offers sound underwriting and consumer protection principles that institutions and all residential mortgage providers should consider when making residential mortgage loans. CSBS and AARMR are already working to develop a parallel statement for state supervisors to use with state-supervised entities. All 50 states will be expected to adopt the statement on subprime lending, providing state agencies with an additional supervisory tool to protect consumers, ensure sound underwriting standards, and hopefully decrease the number of foreclosures nationwide.

CSBS believes the Guidance on Nontraditional Mortgage Product Risks and the Statement on Subprime Mortgage Lending strike a fair balance between encouraging growth and free market innovation and draconian, stern restrictions.

State Predatory Lending Laws

Currently, 36 states plus the District of Columbia have enacted predatory lending laws.[4] Attached as Exhibit B is a list of chart of state predatory mortgage lending statutory provisions. First adopted by North Carolina in 1999, these state laws supplement the federal protections of the Home Ownership and Equity Protection Act of 1994 (HOEPA). The innovative actions taken by state legislatures have prompted significant changes in industry practices, as the largest multi-state lenders have adjusted their practices to comply

[4] Source: National Conference of State Legislatures.

with the strongest state laws. All too often, however, we are frustrated in our efforts to protect consumers by the preemption of state consumer protection laws by federal statutes. Preemption must be used for the benefit of both business and consumers.

State Enforcement of Consumer Protection Laws

In addition to the extensive regulatory and legislative efforts, state attorneys general and state regulators have cooperatively pursued unfair and deceptive practices in the mortgage market. Through several settlements, state regulators have returned nearly one billion dollars to consumers. A settlement with Household resulted in $484 million paid in restitution, a settlement with Ameriquest resulted in $295 million paid in restitution, and a settlement with First Alliance Mortgage resulted in $60 million paid in restitution. These landmark settlements further contributed to changes in industry lending practices.

But successes are sometimes better measured by actions that never receive media attention. States regularly exercise their authority to routinely examine mortgage companies for compliance not only with state law, but with federal law as well. These examinations are an integral part of a balanced regulatory system. Unheralded in their everyday routine, examinations identify weaknesses that, if undetected, might be devastating to the company and its customers. State examinations act as a check on financial problems, misapplication of consumer protections and sales practices gone astray. Examinations can also serve as an early warning system of a financial institution conducting misleading, predatory or fraudulent practices. Attached as Exhibit C is a chart of enforcement actions taken by state regulatory agencies against mortgage providers. As an example, in 2006, states took 3,694 enforcement actions against mortgage lenders and brokers.

Proposals for Fixing the Residential Mortgage Market

The ongoing upheaval in the residential mortgage market has caused justifiable concerns among policymakers, regulators, investors, members of the industry, and consumers. Any approach Congress takes to improve the mortgage market, however, should focus first and foremost upon the borrowers. A Congressional bail out of subprime lenders, brokers and investors would greatly undercut market discipline and fail to provide relief to those who need it most; the consumers. I offer the following suggestions.

First, Congress should update the federal predatory lending law to incorporate the time-tested consumer protections implemented by the various states over the last decade, as embodied by legislation proposed last session in the House of Representatives by Reps. Miller, Watt and Frank. Introduced last year as H.R. 1182, the Miller-Watt-Frank bill would have created a national standard that would set sensible limits on high-cost subprime loans, while retaining the states' ability to address new abuses in the market. In addition, Congress should state clearly and unambiguously that lenders are required to consider a borrower's ability to repay a loan.

Second, we need to develop a standard to prevent unscrupulous subprime lenders and brokers from taking advantage of borrowers with credit problems. Congress should require that a loan to a subprime borrower should be a thirty-year fixed rate loan that most consumers understand. Any other choice of subprime loan should depend on the borrower taking affirmative action to opt out of the default loan and receiving in-person independent counseling on the benefits of the transaction. Subprime lending should be a bridge to create sustainable homeownership, not a detour into a second-class, high-priced mortgage system.

Third, Congress should support the coordination of the supervision of non-bank mortgage brokers and lenders by the states. CSBS and AARMR have, in partnership with the NASD, organized a coordinated national system to license and track the activities of these enterprises. Through working on the development of the system, states and a number of industry representatives have begun a dialog that will lead to broadly consistent national standards with regard to licensing of firms and individuals. Congress can promote this system through funding the start-up of the system and by requiring states that do not wish to join the system to affirmatively opt-out of the system. Given the same kind of Congressional "encouragement" that the insurance regulatory community got in Gramm-Leach-Bliley, this system can be a valuable resource in regulating the market in the future.

Fourth, Congress already has tools at its disposal to facilitate the flow of credit to responsible subprime lending. Congress should take immediate steps to modernize FHA to enable it to be a viable option for homeownership by borrowers with credit blemishes. Much of the growth of the subprime industry came at the expense of FHA. Clearly, Congressional concerns over the solvency of the FHA insurance fund led it to overreact and hamstrung the FHA from serving the subprime market.

In addition, Congress should encourage the GSE's to devote their primary attention to affordable housing for all Americans, particularly the subprime market. The GSEs have done wonders to increase the liquidity in the conventional mortgage market. In addition to their potential direct impact in the subprime market, the standards set by the GSEs for loans they purchase have an impact that ripples through the marketplace.

With over a million subprime loans scheduled to reset this year[5], state and federal regulators should encourage our supervised entities to reach out to those consumers who will be affected. The communication with these borrowers should provide a clear explanation for their loan reset, and provide the exact dollar amount that their monthly payment will increase and when it will occur. My message to consumers is that you can work with your mortgage servicer on your payment problems before you reach foreclosure.

Conclusion

Ultimately, there is a trade-off between increasing the availability of credit in the mortgage market and the level of foreclosures. CSBS is concerned by this trade-off. My fellow state supervisors and I are finely tuned to the needs of the communities we serve. Like members of Congress, state supervisors are not only concerned with national trends, but with the overall economic health of our local communities. Even a relatively small number of foreclosures can be devastating to a small town.

As regulators, we must find a balance between encouraging market innovation, product choice and credit availability with consumer protection. The states will continue to improve supervision of the mortgage industry by strengthening state statutes, signing on to the CSBS-AARMR mortgage licensing system, or adopting parallel guidance for our regulated entities. Only by continuing coordination on a nationwide level can we create an effective supervisory framework that both protects consumers and supports financial services providers.

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[5] Source: *Mortgage Payment Reset: The Issue and the Impact*, by Christopher L. Cagan, Ph.D., First American CoreLogic, Inc. 4 First American Way, Santa Ana, CA, 92707. March 19, 2007.

Subprime lending can prove very beneficial to consumers as they try to access the capital necessary to purchase a home. Product choices and payment options allow consumers the flexibility to tailor their mortgage to their specific needs. These innovations in the mortgage market are positive developments. But with any market expansion and increase in complexity, there will also be an increase in the opportunity for predatory lending and fraudulent lending practices. As a state financial regulator, my charge is to protect the consumers of Massachusetts while allowing the financial service providers the opportunity to compete with their fellow providers and flourish in the marketplace in a safe and sound manner.

The interagency guidance on nontraditional mortgage products, the proposed statement on subprime mortgage lending, the parallel guidance, and the nationwide licensing system developed by CSBS and AARMR address safety and soundness concerns within the mortgage industry and provide effective consumer protections. These tools will improve the quality of mortgage loans, which I believe will therefore decrease the number of residential foreclosures.

It is not the goal of CSBS to limit credit access to subprime borrowers or those consumers that are traditionally underbanked. My fellow state supervisors and I will continue to vigilantly supervise the residential mortgage industry to improve the quality of credit available to consumers, improve standards for loan providers, ensure consumer protection provisions, and punish those who engage in predatory or abusive practices. The economy is not benefited by putting consumers in homes they cannot afford. Instead, we are working towards a marketplace with cooperative and seamless supervision that benefits both consumers and providers.

Thank you again for your invitation to testify today and for this Subcommittee's interest in improving our mortgage market system.

Exhibit A: Examples of Actions Taken by Individual States

In addition to the cooperative efforts of state regulators through CSBS and AARMR, I have detailed a small sampling of state regulator actions in the mortgage arena. There are similarities and differences in the initiatives undertaken by the states. I believe this differentiation is a sign of health in state supervision. State regulators with a deep knowledge and understanding of local circumstances are free to tailor their supervisory framework to the unique conditions in their state.

Arizona

In January, the Arizona Department of Financial Institutions (DFI) issued the parallel Guidance for Nontraditional Mortgage Product Risks developed by CSBS and AARMR.

The DFI has led other state and federal regulators to form a mortgage fraud task force. The task force, created by Superintendent of Financial Institutions Felecia Rotellini, consists of the Arizona DFI, the Arizona Department of Real Estate, the Arizona Housing Department, the Federal Bureau of Investigation, the Department of Housing and Urban Development, the Internal Revenue Service, the Arizona State Board of Appraisers, and local law enforcement. The task force was formed to pool agency resources, to share expertise and to more effectively investigate and prosecute, both civilly and criminally, individuals engaging in mortgage fraud.

In January 2007, legislation was introduced in the Arizona legislature that would require all loan officers and originators be licensed. This legislation would also define mortgage fraud as a felony, punishable up to 10 years in prison.

The DFI has been investigating mortgage fraud and illegal lending practices since 2005. In January 2006, Superintendent Rotellini created the Regulatory Enforcement Unit

to assist state examiners with their increased caseload and increased enforcement actions. Also during 2006, the DFI hired two field investigators to conduct interviews and focus on the illegal practices in the residential mortgage industry. In the past three months, the DFI has been inundated with complaints, tips, and information about predatory practices, mortgage fraud, and foreclosure rescue schemes. The DFI has been working closely with state and federal law enforcement, the professional associations that represent the mortgage and real estate industries, and journalists to heighten consumer and industry awareness, to weed out the worst actors, and to send a message that industry will be held accountable for predatory or abusive lending practices.

California Department of Corporations

The Department of Corporations actively pursues its mission to protect consumers. In addition to conducting standard regulatory exams of its licensees, including those that make subprime loans, the Department collects information regarding the extent and nature of the nontraditional mortgage loan products offered by its licensees.

The Department has also taken Administrative action to protect borrowers. The Department issued a Desist and Refrain Order to New Century Mortgage Corporation and an Order to Discontinue Violations and Unsafe and Injurious Practices to New Century Mortgage Corporation and Home 123 Corporation on March 16, 2007.

The Department has implemented additional oversight procedures. Specifically, to help anticipate and prevent closure of a mortgage company due to adverse financial conditions, the Department has identified the largest lenders among its licensees, companies that together comprise approximately two-thirds of the total loans made by its licensees. The Department has requested financial information from those lenders; a review of that information will allow the Department to identify which companies require

closer monitoring. "Closer monitoring" consists of the company providing the Department with daily reports regarding the status of loans in the pipeline; the status of warehouse lines of credit; and, if necessary, a Corrective Action Plan to address any significant deficiencies.

In the event of a sudden and unanticipated closure of one of its licensees, the Department takes several steps to help protect borrowers. These steps are summarized as follows:

First, the Department contacts the company's CEO, and directs them to provide specific information concerning pending loans and company operations, including consumer complaints.

Second, the Department communicates vital information concerning the closure to consumers, including updates and contact information, via the Department's website.

Third, the Department will investigate the company's activities to determine responsiveness in handling consumer issues.

Fourth, the Department will examine the circumstances involving the closure and take additional actions as necessary.

Failure to comply with any demands of the Department as outlined above (corrective action or other steps) could result in more serious enforcement action by the Department.

The Department is in the process of adopting additional regulations, including the CSBS-AARMR guidance on nontraditional mortgage product risks. The Department is also working with other state regulators to address this national problem.

In order to maximize consumer protections and customer service, the California Departments of Corporations, Real Estate, Financial Institutions and the Office of Real

Estate Appraisers have collaborated to develop a centralized Internet location for consumers to verify licensing information from all four departments at once. The combined California Real Estate and Financial Services License Status check feature can be accessed from any of the aforementioned departments' websites. Consumers are encouraged to check the license status of real estate agents, mortgage brokers, mortgage lenders and others involved in the processes of purchasing or refinancing their homes before signing any documents.

Since loans can be made or arranged under a real estate broker license as well as a Department of Corporations (DOC)-issued Residential Mortgage Lender (RML) license and a California Finance Lender (CFL) license, the DRE and the DOC have a Memorandum of Understanding (MOU) to cross-check license applicants and disciplinary actions. This arrangement prevents a mortgage loan broker who has been disciplined by one department from obtaining a license from the other to continue operating. In the last fiscal year, the Departments crossed-checked over 6,000 applicants. In addition, to lessen the burden on consumers, the DRE and DOC proactively refer complaints to one another.

California Department of Real Estate

The California Department of Real Estate (DRE) licenses and regulates the activities of real estate salespersons and brokers. In order to engage in licensed activity, a salesperson must be employed and supervised by a broker. Licensed activity includes, among other things, the listing and sale of real property, property management and mortgage brokering.

At the end of fiscal year 05/06, there were 137,410 license real estate brokers and 366,734 salespersons for a total licensee population of 504,144. Licenses are generally valid for four years.

In order to become licensed as a real estate broker or salesperson in California, an individual must have completed certain pre-license educational requirements, and in most cases experience requirements for broker applicants, as well as pass a written examination. All applicants are fingerprinted and background reports are received from both the California Department of Justice and the Federal Bureau of Investigation. Once an individual is licensed, the California Department of Justice also provides subsequent arrest notices to the DRE should one occur. Real estate licenses are issued for a period of four years and there are continuing education requirements which must be met for all renewals. Unless working for an exempt institution, all individuals who negotiate loans in California must be licensed as either a real estate broker or as a properly licensed salesperson who works under the supervision of a real estate broker.

The DRE has the authority to issue and discipline real estate licenses. Discipline can range from a Public Reproval, suspension, or revocation of a license. The DRE has limited authority to fine and cannot criminally prosecute cases. However, referrals to criminal enforcement agencies are made when appropriate. Less substantial violations are addressed with a corrective action letter and these are not counted in the enforcement action statistic totals.

In the area of enforcement, it should be noted that California does have a predatory lending law. The three licensing agencies over mortgage lending in California, the DRE, the Department of Corporations (DOC), and the Department of Financial Institutions (DFI) are jointly responsible for enforcing this law within their respective jurisdictions.

As an additional note, the DRE is in the process of adopting regulations to adopt the CSBS-AARMR Guidance on Nontraditional Mortgage Products, which mirrors the interagency guidelines.

Real estate licensees have fiduciary duties to both the lender and borrower when negotiating loans and can be disciplined for violations of the Real Estate Law. Violations include making a misrepresentation, fraud, dishonest dealing, negligence, and criminal convictions. Failing to disclose all material facts about a loan to a borrower or misrepresenting the facts to a lender (such as knowingly misstating a borrower's income) are actionable offenses. A mortgage broker has an obligation to act in the best interest of the borrower.

Although the DRE does random audits, a majority of the audits are in response to complaints filed with the DRE. The 252 audits of mortgage brokers represent 38% of the total audits, even though mortgage brokers represent less than 15% of the licensee population. Of these 252 audits, 186 uncovered potentially actionable violations. Those violations not deemed sufficient to warrant formal disciplinary actions result in a compliance action letter. The most common violations found in the audits involved the failure to provide the proper Mortgage Loan Disclosure Statement. The second most cited violation in the audits involved lack of supervision and improper record keeping. Thirteen of the audits found trust fund shortages, totaling $295,394.

Of the 149 total disciplinary actions based on mortgage loan broker violations, the most common violation cited was failing to provide a borrower with the proper Mortgage Loan Disclosure Statement (29). As noted above, 23 actions were based, in part, on the mortgage broker making a substantial misrepresentation to the borrower. And 17 actions were based, in part, on the broker making a misrepresentation to the lender.

It is worth noting that nearly all the actions were initiated by a consumer complaint. Misrepresentations are difficult to prove without a complainant. And unless patently obvious, misrepresentations are difficult to discover in a random routine audit or

examination of records.

Since loans can be made or arranged under a real estate broker license as well as a DOC issued Residential Mortgage Lender license (RML) and a California Finance Lender license (CFL), the DRE and DOC have a Memorandum of Understanding (MOU) to cross check license applicants and disciplinary actions. This arrangement prevents a mortgage loan broker who has been disciplined by one department from obtaining a license from the other to continue operating. Last fiscal year, the Departments crossed checked over 6,000 applicants.

In addition, to lessen the burden on consumers, the DRE proactively refers complaints to the DOC when it is determined the activity was conducted under a DOC issued license and not a DRE issued broker license. Last fiscal year, the DRE referred 75 complaints to the DOC.

As noted above, the DRE is an administrative agency and does not have the authority to prosecute criminal or civil violations. Such violations may be pursued by local municipalities or the Attorney General (AG). Existing law allows a district attorney or the AG to bring civil actions for unfair business practices and misleading advertising.

The DRE routinely makes referrals to local law enforcement and provides technical assistance when appropriate. Last fiscal year, the DRE either referred or provided assistance on over 35 criminal cases. Many of the criminal referrals involved loan fraud.

Los Angeles County has also established a Real Estate Fraud Task Force of which DRE is a member. The task force meets once a month and participants include Los Angeles Police Department, Los Angeles Sheriff's Department, the Department of Housing and Urban Development, the Internal Revenue Service, the Federal Bureau of Investigation, and the California Departments of Corporations and Consumer Affairs.

With respect to broker education, the DRE has already begun a series of efforts to further ensure brokers fully understand their responsibilities to inform borrowers of the relative merits and risks of nontraditional mortgages. The DRE has recently published an article explaining that brokers have a duty to fully explain to a borrower the merits and risks of alternative mortgage programs before the point of document signing. The article also makes the point that real estate brokers have a fiduciary duty to the borrower and as such, must act in the best interest of the borrower.

With respect to marketing and advertising, existing law requires that real estate brokers disclose all material facts about a product in the ad or materials used to solicit borrowers. Any promotion of a nontraditional mortgage must include the material facts of the product so the ad or promotional material is not misleading. This would include disclosures of the possibility of negative amortization, frequency of payment or rate adjustments, and the amount of the balloon payment if the program is not fully amortized. This is also true of any verbal discussion a broker has with a borrower.

The DRE has also made an extensive effort to educate borrowers so they may make informed decisions. In this regard, the premier publication of the DRE is the consumer booklet on "Using the Services of a Mortgage Broker". This booklet educates a borrower on what questions to ask to ensure an understanding of the loan terms, especially the terms related to nontraditional mortgages. This booklet was first produced over 15 years ago and is updated periodically. The department is currently in the process of updating the booklet again so it more accurately reflects the information in the guidance.

Massachusetts

In the Commonwealth of Massachusetts, mortgage supervision has been the primary focus of the Division of Banks for well over a year.

In 2006 alone, the Massachusetts Division of Banks issued a total of 104 formal and informal enforcement actions against mortgage lenders and brokers. Included in these actions were several cease and desist orders essentially shuttering companies found to be intentionally overstating income on reduced documentation loans or engaging in other types of deceptive practices. In September 2006, the Division issued an industry letter relative to reduced documentation loans indicating that severe action will be taken should evidence of mortgage fraud be found and implemented emergency amendments to their regulations governing mortgage lenders and brokers, significantly expanding the number of existing prohibited acts and practices that constitute grounds for the issuance of cease and desist orders and license suspension or revocation.

Massachusetts was one of the first to adopt the parallel guidance on nontraditional mortgage product risks, developed by CSBS and AARMR, in the form of a regulatory bulletin. This action is essential toward ensuring a level playing field is maintained within the mortgage market and that the consumer protections within the guidance are enforced uniformly.

Finally, in an effort to develop a comprehensive strategy to address increasing foreclosure rates, the Division of Banks hosted a Mortgage Summit in November 2006. Nearly 50 individuals representing 29 government, industry, and nonprofit organizations attended the Mortgage Summit with the stated goal of seeking to address the increasing number of mortgage foreclosures across Massachusetts and to develop a statewide foreclosure prevention strategy that will put into place lasting measures to help consumers confronted with the loss of their homes.

Following the Summit, two Working Groups were established to focus on Rules and Enforcement and Consumer Education and Foreclosure Assistance. The goal of the

Working Groups is to take the ideas and suggestions from the Summit and develop specific recommendations. Since January, the Working Groups have met every two weeks and set a deadline of March 31 to conclude their deliberations.

The new legislative session is also underway. Several bills dealing with mortgage foreclosures have already been introduced, including provisions which would require loan originators to be licensed and extend the Massachusetts Community Reinvestment Act to licensed mortgage lenders.

Minnesota

In December 2006, the Minnesota Department of Commerce issued the Guidance for Nontraditional Mortgage Product Risks developed by CSBS and AARMR to all state-licensed entities.

The Department's 2005 legislation, which became effective on January 1, 2006, requires licensed residential mortgage originators to conduct background checks on loan officers and prohibits a person convicted of a financial crime from serving as a loan officer without prior written consent of the Commissioner of the Department of Commerce. These requirements are very similar to Section 19 of the FDI Act.

A Department proposal presently under consideration by the Minnesota state legislature would improve and strengthen regulation of mortgage originators. The proposal, if enacted, would require the following:

1. That all licensees be a business entity with a minimum tangible net worth of $250,000 (or a surety bond or letter of credit of $100,000);
2. Require an affirmation that they are in compliance with the background check requirement;

3. Require maintenance of a perpetual roster of loan officers that would be provided to the Department on demand;
4. Require loan officers to have 16 hours of education on state and federal mortgage laws before serving;
5. Give the Department of Commerce the authority to examine licensees and charge for these exams; and
6. Make mortgage fraud a specific crime in Minnesota, which is based upon a recent law passed in Georgia.

This proposal is expected to be enacted.

The Department of Commerce has recently halted a kickback scheme and imposed enforcement penalties of more than $1 million on title insurance companies that set up sham affiliated businesses with real estate agents, mortgage originators and developers to get around state and federal laws prohibiting direct payments for referrals. The Department identified 35 affiliated business arrangements between First American and more than 600 referral partners that included real estate agents and brokers, mortgage originators, building contractors, land developers, and others.

New York

The New York State Banking Department has been a regulatory leader in identifying and responding to the market challenges posed by the subprime sector. The Department supervises the activities of mortgage bankers and brokers operating in the state. Currently the Department licenses 321 mortgage bankers and 2453 mortgage brokers. Out of the 520 employees currently working at the Department, 61 examiners are assigned to the Mortgage Division and charged with supervising regulated mortgage bankers and brokers.

A detailed discussion of the numerous initiatives and examination strategies employed in this effort is beyond the scope of this summary, but the following highlights are representative of the Department's decisive role:

Early diagnosis of the problem. In 1999, the Department had already identified the potential for crisis in the subprime sector and launched a comprehensive campaign against predatory lending accordingly. This campaign was a highlight of the Department's Annual Report for that year (refer to page seven of the 1999 Annual Report) and included increased consumer education, expanded probes by the Criminal Investigations Bureau, and the formation of the Fair Lending Unit.

Specialist examination support. The Fair Lending Unit provides specialist expertise that has increased the effectiveness and efficiency of the examination process. The Unit assists the examiners by providing cutting-edge statistical and underwriting analyses that focus risk and pinpoint findings. Reports prepared by the Unit's Specialists can quantify the amount that a consumer has been overcharged down to the penny. This has led to substantive changes in industry practice; for example, the discontinuance of single-premium credit life insurance. The Unit also played a key role in obtaining settlements for the Department and consumers, such as in Delta Funding and Ameriquest.

Enforcement Actions. In the area of enforcement, the New York State Banking Department is part of several federal and state law enforcement task forces and works closely with these institutions to provide technical assistance as they prosecute instances of mortgage fraud in New York State. In 2006, through the Department's supervisory process, 468 institutions had their licenses or registrations suspended, 8 institutions had their licenses revoked, and fines were levied against 45 institutions for a total of $400,840.

Also in 2006, the Banking Department increased its per day fine for violations of its mortgage laws and regulations.

Positive interagency relationships. New York took the lead in developing a dedicated examination support unit to combat unfair lending practices and exported this concept to other agencies. The Fair Lending Unit is a model and a resource that has influenced other state and federal regulators. For example, the FDIC also developed a nationwide Fair Lending Specialist program, and the NYSBD Fair Lending Unit trained specialist staff from other state and federal regulators. The NYSBD, through the Fair Lending Unit, has been an example of the proactive approach to consumer protection that should be adopted nationally. This positive cooperation between agencies works to eliminate jurisdictions where abusive lenders may hide.

High standards for supervised institutions. The Department also requires that all applications for new charters or licenses, mergers and acquisitions, and changes in control be reviewed for fair lending prior to approval. Institutions indicate the robustness of their compliance strategy through the submission of a Fair Lending Plan that is reviewed by the Specialists of the Fair Lending Unit. Only when a lender demonstrates their ability to comply with their responsibilities under fair lending laws through sound lending practices is an application approved.

Innovative regulations. New York State has some of the most comprehensive consumer protection laws and regulations in the nation. For example, lenders making loans in New York may only charge a prepayment penalty within the first year of any mortgage on which the interest rate exceeds 6%.The Department developed Part 41 of the General Regulations of the Banking Board to place certain limitations on high-cost home loans. While the possible effect of pre-emption on Part 41 remains an outstanding issue, the

regulation has been among the first of its kind for states and has brought the matter of anti-predatory lending to the attention of national legislators. Recently, New York strengthened protections for consumers with the passage of the Home Equity Theft Prevention Act on July 26, 2006 and a Mortgage Loan Originators Bill on December 6, 2006. The Home Equity Theft Prevention Act mandates specific disclosures that must be made to homeowners upon the filing of a notice of pendency. The Mortgage Loan Originators Bill requires that any person who originates loans on residential property in the State of New York be authorized annually by the Banking Department and specifies educational requirements that an authorized originator must maintain in order to continue to originate loans in the state.

Services for the underbanked. The creation of the Banking Development Districts (BDD) program has encouraged depository institutions to open branches in underserved communities. When traditional lenders leave a neighborhood, it creates a vacuum that subprime lenders quickly fill. Banks have also been encouraged to fulfill their obligations under the Community Reinvestment Act through the origination of residential mortgages.

Consumer Help Unit. The Department maintains a Consumer Help Unit that monitors a toll-free Consumer Helpline (1-877 BANK NYS) to answer questions, make referrals or mediate between the consumer and the regulated entity when problems arise. The Consumer Help Unit has five trained mortgage examiners as part of its staff who are assigned to specifically address mortgage-related issues. In 2006, the mortgage section of the Consumer Help Unit handled an average of 81 calls per day and was able to secure more than $875,000 in refunds for consumers.

Consumer Outreach. On April 11, 2007, the Department's Consumer Services Division will kick of its "Halt Abusive Lending Tactics and Mortgage Fraud" campaign

which will bring together community groups, government agencies, law enforcement and industry representatives to find ways to promote collaborative efforts aimed at assisting consumers and communities affected by rising foreclosure rates, predatory lending and mortgage fraud.

The key for the Department today is to build on the present momentum created by these past achievements, as controlling the continuing risk to consumers and to the market remains at the forefront of this agency's mission.

North Carolina

Earlier this month, the North Carolina Office of the Commissioner of Banks (NCCOB) issued Guidance on Nontraditional Mortgage Product Risks (NTM guidance) developed by CSBS and AARMR. The North Carolina NTM guidance included a specific discussion of how the NTM guidance fit within the state regulatory scheme, its application to mortgage brokers and mortgage lenders in their different roles, and provided examination procedures used by state examiners to ensure compliance.

This year, NCCOB has supported the introduction of two bills to the General Assembly to improve the mortgage market. The first bill would make mortgage fraud a felony under state law and would simplify prosecution of mortgage fraud at the state level. This legislation is modeled after the Georgia mortgage fraud law, the first of its kind. The second bill would require that all deeds of trust secured by residential property identify the name and license number of a mortgage broker, if one was involved in the transaction. This legislation is the result of a state legislative study commission on foreclosures that has met regularly over the past year.

In addition to the legislative effort on mortgage fraud, NCCOB has hired three additional staff to pursue evidence of mortgage fraud. The NCCOB has trained all of their

mortgage examiners on mortgage fraud (through AARMR training) and have prioritized detecting fraud in their examination process.

NCCOB has supported the development of improved standards in the mortgage brokerage business, through the encouragement of an industry-led certification program for mortgage broker firms.

Pennsylvania

In Pennsylvania the banking department invested more than a year researching residential foreclosures across the state. Their study revealed that the state's 2003-2004 spike in foreclosure rates could not be explained simply by cyclical economics or more-traditional foreclosure factors, such as illness, job loss or divorce. The study documented that subprime loans disproportionately represented a majority of loans that resulted in foreclosure. Data also made clear, however, that not all subprime loans are predatory loans. When responsibly applied, subprime products help borrowers for whom homeownership may otherwise have been impossible.

In 2005, pursuant to its request, the banking department provided a report to the Pennsylvania House of Representatives' Commerce Committee. The report included recommendations developed by the department and informed by vigorous debate with policymakers, financial industry leaders and consumer advocates.

Recommendations fell into roughly three categories: changing the way the banking department conducts business under existing authority; adding specificity to present statutes via regulation; and amending current state laws. Significant progress has been made over the past two years in achieving these recommendations, including:

1. Changing the way the Pennsylvania Department of Banking conducts business under existing authority.

To date, the department has:

- Doubled the number of examiners who focus on nondepository licensed entities, including mortgage bankers and brokers;
- Executed interagency information-sharing agreements and expanded the department's licensing division to ensure effective background checks on applicants;
- Created an investigations unit which has focused more than 80% of its efforts in the past two years on entities involved in mortgage lending;
- Supported the Pennsylvania Office of Financial Education, added staff to its consumer hotline, created a position of consumer group liaison, coordinated with other state agencies and developed print/electronic materials to educate consumers about the rapidly innovating mortgage marketplace;
- Secured nearly $1.2 million in refunds for the state's mortgage consumers in 2006;
- Issued a policy statement to licensees that defines dishonest, fraudulent, unfair, unethical and illegal practices under existing state law for which the department can suspend, revoke, or refuse to renew a license; and
- Emphasized multi-state coordination in addressing concerns with regard to the mortgage marketplace (including but not limited to the landmark Ameriquest settlement; developing the CSBS-AARMR guidance on nontraditional mortgage product risks; working toward and providing financial support for a multi-state licensing system; developing collaborative examiner education).

2. Adding specificity to present statutes via regulation.

In July 2006, the Pennsylvania Department of Banking published for public comment an advanced draft of a proposed regulation to define proper conduct of business for mortgage bankers, brokers, and consumer discount companies that originate mortgage loans under Pennsylvania law. In very general terms, the proposed regulation requires two things. First, it requires additional (but not duplicative) disclosures of important loan terms to consumers. Such terms may include but are not limited to, whether a loan: escrows taxes and insurance; includes a balloon payment or prepayment penalty; employs a variable interest rate or negative amortization. Second, it requires that state-licensed mortgage professionals reasonably determine a borrower's ability to repay the offered loan given all its terms and conditions, not just the introductory payment.

It is expected that a revised draft will be published and begin the state's independent regulatory review process in the coming weeks.

3. Amending current state law.

After more than a year of working with policymakers, financial industry leaders and consumer advocates, six bills were crafted and introduced in the Pennsylvania legislature in the summer of 2006. Because last year was an election year and a new legislative session began in January, it was necessary to re-introduce the bills. As introduced on February 21, 2007, Senate Bills 483 – 488 would, among other provisions:

- Require individual mortgage loan originators to be licensed by the state;
- Eliminate realtor, builder and insurance exemptions from the state's mortgage lending statutes;
- Increase the cap of the state's loan interest and protection law and allow for annual adjustment;

- Add members to the state's appraiser board and increase maximum civil penalties;
- Create a structure to monitor foreclosures on a statewide basis;
- Enhance the state's emergency foreclosure assistance program; and
- Provide the banking department with certain additional enforcement authority.

Washington

In 2006, Washington State amended the Mortgage Broker Practices Act to include licensing for loan originators, routine examination authority for mortgage brokers and stricter enforcement provisions. The Department of Financial Institutions added several new examiners and enforcement attorneys to handle an increasing caseload of examinations, complaints, predatory lending investigations and mortgage fraud.

The 2006 Legislature also amended the state's mortgage fraud law extending the sunset period to 2011. With an original sunset of 2006, the amendment showed the success of this unique law focused on the funding of prosecutions and cooperative working agreements between the DFI and local prosecutors. With an allocated budget of over $1 million per year specifically dedicated to mortgage fraud investigation and prosecution the agency has been able to investigate over 30 fraud cases, and has seen several prosecutions ranging from misdemeanor to felonies with sentencing up to seven years.

Despite its geographical remoteness, Washington has long been a leader in the investigation of predatory lenders operating at the national level. In cooperation with the Attorney General, Washington DFI was a leader in three of the four largest national predatory lending settlements, and each year conducts numerous regional and state enforcement actions under its administrative authorities. These actions are generally

significant; however, frequently they do not receive appropriate press recognition due to their localized nature.

Exhibit B: Chart of State Predatory Mortgage Lending Statutory Provisions

Source: National Conference of State Legislatures

State	Statutory Citation	Flipping Banned	Negative Amortization Banned	Prepayment Penalties Banned	Financing Credit Insurance Banned	Consumer Credit Counseling Provision	High Debt to Income Ratio Provision (Ability to repay loan)
AL							
AK							
AR	Ark. Stat. Ann. §23-53-101 *et seq.*	X	X		X	3rd party required	Give due regard
AZ							
CA	Cal. Finance Code §4970 *et seq.* and §4973 *et seq.*	X	X			Disclosure	Presumption at 55%
CO	Colo. Rev. Stat. §5-3.5-101 *et seq.* and §38-40-105	X	X			Notification	Give due regard
CT	Conn. Gen. Stat. §36a-746 *et seq.* and §36a-521		X			Notification	Presumption at 50%
DE							

DC	D.C. Code Ann. §26-1114. and §26-1151.01 *et seq.*		X	X			Give due regard
FL	Fla. Stat. §494.0078 *et seq.*	X	X			Notification	Give due regard
GA	Ga. Code §7-6A-1 *et seq.*	X	X		X	3rd party required	Presumption at 50%
HI							
ID							
IL	Ill. Rev. Stat. ch. 815, 137/1 *et seq.* and ch. 765, 77/70	X	X		X	Notification	Presumption at 50%
IN	Ind. Code 4-6-12 and 24-9-1 *et seq.*		X		X	3rd party required	Give due regard
IA							
KS							
KY	Ky. Rev. Stat. §294.010 *et seq.* and §360.100	X	X		X	Notification	Presumption at 50%
LA	La. Rev. Stat. Ann. 6:1096(G) and 9:3572.6(C)						
ME	Me. Rev. Stat. Ann. tit. 9-A, §2-509, tit. 9-B, §429; tit.		X				Give due regard

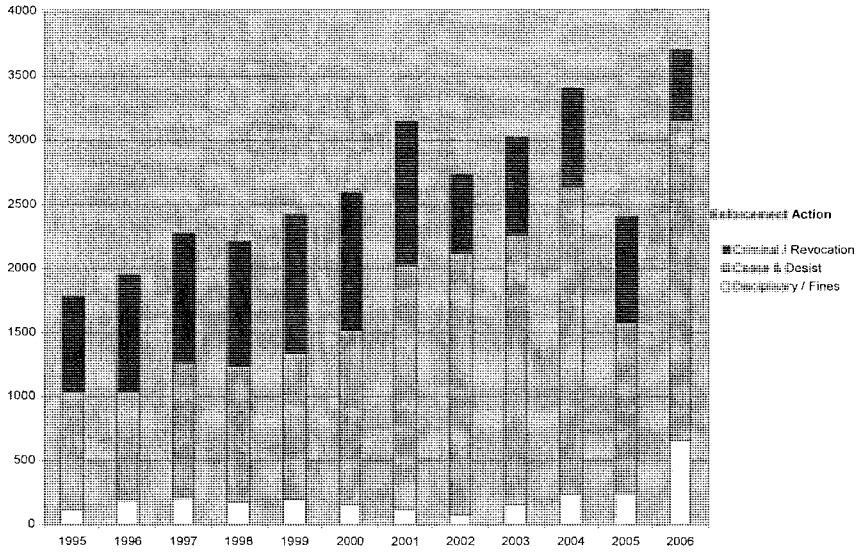
	9-A, §8-103, §8-206-A, tit. 9-A, §10-102 and tit. 33, §506						
MD	Md. Commercial Law Code §12-127, 12-311, 12-409.1 and 12-1029	X	X		X	3rd party required	Presumption at 45%
MA	Mass. Gen. Laws Ann. ch.183, 28C		X	X		3rd party required	Presumption at 50%
MI	Mich. Comp. Laws §445.1631 *et seq.*		X		X	Notification	
MN	Minn. Stat. §58.137					Notification	
MS							
MO	Mo. Rev. Stat. 375.937						
MT	Mont. Code Ann. §32-5-306						
NE	Neb. Rev. Stat. §45-702, 45-704 and 45-705				X		
NV	Nev. Rev. Stat. §598D.01			X	X		Give due regard

	0 *et seq.*						
NH	N.H. Rev. Stat. Ann.140: 1 *et seq.*						Give due regard
NJ	N.J. Rev. Stat. 46:10B-22 *et seq.*		X		X	3rd party required	
NM	N.M. Stat. Ann. §58-21A-1 *et seq.*	X	X	X	X	3rd party required	Give due regard
NY	N.Y. Banking Law 6-l	X	X		X	Notification	Give due regard
NC	N.C. Gen. Stat. §24-1.1E and §24-10.2 and §53-243.01 *et seq.*	X	X	??		3rd party required	Presumption at 50%
ND							
OH	2006 S.B. 187 Ohio Rev. Code Ann. §1322.062, 1322.07 and 1322.08	X	X	X	X		Give due regard
OK	Okla. Stat. tit. 14A, §3-204 and tit. 59, §2081 *et seq.*	X					Give due regard
OR							
PA	Pa. Cons. Stat. tit. 63,					Notification	Presumption at 50%

	§456.101 *et seq.*						
RI	2006 Chapters 569 & 573 R.I. Gen. Laws §34-23-5 R.I. Gen. Laws §34-25.2-1 *et seq.*	X	X		X	3rd party required	Presumption at 50%
SC	S.C. Code Ann. §37-23-10 *et seq.*	X	X		X	3rd party required	Presumption at 50%
SD							
TN	2006 Public Chapter 801	X					Presumption at 50%
TX	Tex. Finance Code §343.001 *et seq.* and Tex. Gov. Code §2306.001 *et seq.*		X	X			Give due regard
UT	Utah Code Ann. §61-2d-101 *et seq.*		X		X	Notification	
VT							
VA	Va. Code §6.1-422.1 and §6.1-422	X					
WA	Wash. Rev. Code §31.04 *et*						

	seq.						
WV	W. Va. Code §31-17-1 *et seq.*			X			
WI	Wis. Stat. Ann. §428.202 *et seq.*	X	X		X	Notification	Give due regard
WY							

Exhibit C: Enforcement Actions by State Regulatory Agencies against Mortgage Providers



Source: Mortgage Asset Research Institute

Testimony of Michael D. Calhoun
Center for Responsible Lending

Before the U.S. House Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

The New Regulatory Guidance on Subprime Hybrid Mortgages:
Regulators and Response
March 27, 2007

Chair Maloney, Ranking Member Gillmor, and members of the Committee, thank you for holding this hearing to focus on regulatory actions related to subprime hybrid mortgages. These mortgages have had, and will continue to have, a significant negative impact on consumers, and we appreciate the opportunity to comment on the problem and proposed solutions.

My name is Michael Calhoun, and I serve as the President of the Center for Responsible Lending (CRL) (www.responsiblelending.org). CRL is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL began as a coalition of groups in North Carolina that shared a concern about the rise of predatory lending in the late 1990s.

CRL is an affiliate of Self Help (www.self-help.org), which consists of a credit union and a non-profit loan fund. For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans. Self-Help has provided over $5 billion of financing to over 50,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country, with an annual loan loss rate of under one percent.

Before I took my current position with CRL, I worked in leadership roles in Self-Help, including overseeing our secondary marketing operations, where we generated funds for home lending by selling our mortgages as investments to other parties. I highlight this previous role, because I think it is important for you to understand that I have direct lending experience with a subprime lender. In fact, Self Help began making home loans to people with less-than-perfect credit in 1985 when that was unusual in the industry. We believe that homeownership represents the best possible opportunity for families to build wealth and economic security, allowing them to take their first steps into the middle class.

Since 2001, CRL has conducted a great deal of careful research on mortgage lending in the subprime market. We have looked at the costs of predatory lending and a number of issues involving excessive fees, unfair pricing and the disparate effects of abusive practices on African Americans, Latinos, senior citizens and rural homeowners. Three months ago, we issued a report showing that subprime mortgages are resulting in massive foreclosures. We found that nearly 20 percent of subprime mortgages made during the

past two years have already failed or will end in foreclosure and loss of the family's home. That's one in five final foreclosures, representing the irrevocable loss of a home in every instance. In the report, we identified hybrid mortgages—also known as "2/28s," "3/27s," and "exploding" adjustable-rate mortgages—as one of the primary culprits behind this epidemic of home losses.

Today, with the market turmoil surrounding subprime lending, our concerns have been affirmed by many sources. In one example, the investment bank Lehman Brothers recently issued an analysis on subprime performance that, referring to subprime mortgages made in 2006, estimated that "cumulative defaults may run as high as 30 percent."[1] This level of home losses would be catastrophic, representing the worst disaster in the mortgage market since the Great Depression.

Federal law governing abusive lending practices is severely outdated, leaving consumers with scant protections against these losses. Until the federal financial regulators issued the Proposed Statement on Subprime Mortgage Lending we are discussing today (hereafter referred to as "the March 8 Statement" or "the Statement"), there were no meaningful restrictions on the lax underwriting and poor business practices that have produced the exploding ARMs that have flooded the subprime market.[2] We commend the regulators for issuing this Statement, which explicitly charges depository institutions with responsibly underwriting subprime loans by evaluating the borrower's ability to repay the debt after the interest rises to the fully-indexed rate.[3]

The March 8 Statement is an important step in the right direction, but regulators, policymakers, lenders and investors all need to take actions to assist subprime borrowers in distress and ensure that this debacle never happens again.

The lending industry is opposing stronger consumer protections, saying that such protections would reduce access to mortgages. The truth is that this market has been thwarting homeownership rather than supporting it. Between 1998 and 2006, only an estimated 1.4 million first-time home buyers purchased their home with a subprime loan. When those loans are stacked against past and projected foreclosures resulting from subprime mortgages, this market is producing a significant net loss of homeownership for almost one million families. I will elaborate on this point later in the testimony.

My two main messages to you today are these: One, there is a difference between increasing the volume of home loans and expanding homeownership. We have no quarrel with charging a reasonable interest rate premium on subprime home loans, but we take issue with an industry that routinely offers loans that are unsustainable. To truly build wealth through homeownership, we must make it clear that reckless lending practices will not be tolerated.

Second, we cannot in good conscience abandon the homeowners who have been harmed by reckless subprime loans. The market is making corrections now, but these corrections will do nothing for families who have already lost their homes, and those who already received exploding ARMs and will therefore lose their homes in the future. In addition,

the incentives to make damaging loans may lie dormant in the short-term, but they continue to exist, and, unless appropriate actions are taken, will inevitably trigger further abuses in the future.

I respectfully submit six simple and effective policy solutions to stop destructive lending practices in the subprime market and return to sound lending practices.

1. Restore safety to the subprime market by finalizing the Statement with an "ability to repay" standard for all subprime loans. In the March 8 Statement, federal regulators explicitly offer greater protections against the risks posed by exploding ARMs. The Statement says that an institution's analysis of a subprime borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. We strongly urge the regulators to finalize these provisions as soon as possible.[4]

2. Require the Federal Reserve Board to act, or address abuses through the Federal Trade Commission. Current federal law—the Home Ownership and Equity Protection Act of 1994 (HOEPA)—governing predatory lending is inadequate and outdated. However, through HOEPA, Congress mandated that the Federal Reserve Board address mortgage lending abuses on all loans through regulation and gave it broad authority to carry out this responsibility. To date the Board has not used this authority. The Board must address abusive lending practices to prevent another foreclosure crisis in the future. Given the Board's record of inaction, Congress should give parallel authority to the Federal Trade Commission to address harmful practices that have gone on too long.

3. Require government-sponsored enterprises to stop supporting abusive subprime loans. Recently Freddie Mac announced that it would no longer purchase mortgage-backed securities backed by abusive subprime loans, but Fannie Mae has not made a similar commitment. Fannie Mae should follow Freddie Mac's lead and refuse to purchase these securities, the Office of Federal Housing Enterprise Oversight (OFHEO) should prohibit their purchase, and the U.S. Department of Housing and Urban Development (HUD) should stop providing credit for these securities under HUD's affordable housing goals.

4. Hold all industry players accountable for their actions. Lenders, brokers, servicers, investors and trustees should stem the tide of foreclosures by proactively modifying loans to make them sustainable. Lenders should also have greater accountability for brokers' actions, and brokers should have a fiduciary duty to serve the best interests of their clients. And when investors purchase loans, they should assume legal liability for loans that are abusive or predatory.

5. Strengthen existing bankruptcy law to assist homeowners harmed by subprime foreclosures. Many struggling borrowers have no chance for recovery except through bankruptcy, but current bankruptcy law singles out the home mortgage loan as the one debt for which the bankruptcy court cannot provide relief. To assist homeowners who are trying to recover from harmful subprime loans, a modification to the bankruptcy code is necessary and appropriate.

6. Strengthen protections against destructive home lending by passing a strong national anti-predatory lending bill. HOEPA has not kept up with the evolution of abuses in the market, and needs to be updated and strengthened. As HOEPA does today, any new federal law must preserve the right of the states to supplement the law, when necessary, to address new or locally-focused lending issues.

Lower-income and credit-challenged homeowners can become successful homeowners if given reasonable mortgages. For millions of families, sustainable homeownership will ultimately make the difference between merely surviving between paychecks or building savings for a better future. This subcommittee can play a powerful, positive role in shaping a healthy subprime market that will increase the economic strength of this country by contributing to homeownership that moves families forward instead of pushing them back.

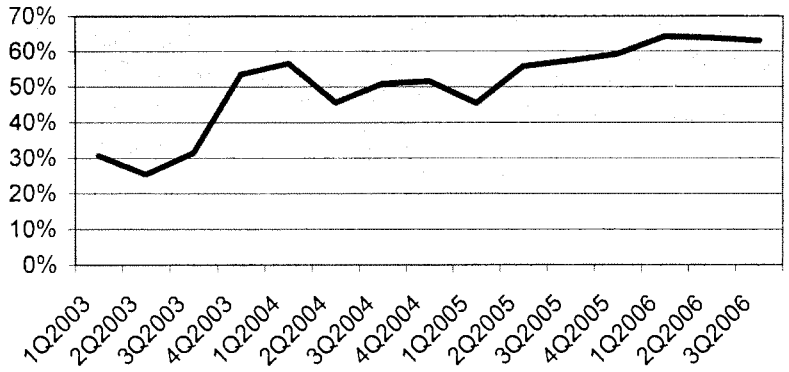
I. Foreclosures in the Subprime Market

Appendix A provides background information on the growth and development of the subprime market. For our purposes today, I will focus on today's most pressing concern: the recent wave of foreclosures in the subprime market, and the factors that drive these foreclosures, with emphasis on high-risk loan products.

A. Foreclosures in the Expanding Subprime Market

In the United States, the proportion of mortgages entering foreclosure has climbed steadily since 1980, with 847,000 new foreclosures filed in 2005.[5] In 2006, lenders reported 354,554 new foreclosure filings for the fourth quarter alone, 47.5 percent higher than the fourth quarter of 2005.[6] In the past 18 months, there have been frequent stories in the media about risky lending practices and surges in loan defaults, especially in the subprime market.[7]

Subprime Foreclosure Starts as a Percent of Total Conventional Foreclosure Starts



Source: MBA National Delinquency Surveys

The graph above shows that foreclosure filings on subprime mortgages now account for over 60 percent of new conventional foreclosure filings reported in the MBA National Delinquency Survey (A "conventional" loan is one that is not insured or guaranteed by a government agency). This fact is striking given that only 23 percent of current originations are subprime, and subprime mortgages account for only 13 percent of all outstanding mortgages.

Late last year we published a report that represents the first comprehensive, nationwide research conducted on foreclosures in the subprime market. The report, "Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners," is based on an analysis of over six million subprime mortgages, and the findings are disturbing. Our results show that despite low interest rates and a favorable economic environment during the past several years, the subprime market has experienced high foreclosure rates comparable to the worst foreclosure experience ever in the modern prime market. We also show that foreclosure rates will increase significantly in many markets as housing appreciation slows or reverses. As a result, **we project that 2.2 million borrowers will lose their homes and up to $164 billion of wealth** in the process. That translates into foreclosures on one in five subprime loans (19.4 percent) originated in recent years. Taking account of the rates at which subprime borrowers typically refinance from one subprime loan into another, and the fact that each subsequent subprime refinancing has its own probability of foreclosure, this translates into projected foreclosures for **more than one-third of <u>current</u> subprime borrowers**.

Another key finding in our foreclosure report is that subprime mortgages typically include characteristics that significantly increase the risk of foreclosure, regardless of the borrower's credit. Since foreclosures typically peak several years after a loan is originated, we focused on the performance of loans made in the early 2000s to determine what, if any, loan characteristics have a strong association with foreclosures. Our

findings are consistent with other studies, and show what responsible lenders and mortgage insurers have always known: Mortgages with built-in payment increases or those based on poorly-documented borrower income substantially boost the risk of foreclosure. For example, even after controlling for differences in credit scores, these were our findings for subprime loans made in 2000:

- Adjustable-rate mortgages had 72 percent greater risk of foreclosure than fixed-rate mortgages.
- Mortgages with "balloon" payments had a 36 percent greater risk than a fixed-rate mortgage without that feature.
- Prepayment penalties are associated with a 52 percent greater risk.
- Loans with no documentation or limited documentation of the applicant's income were associated with a 29 percent greater risk.
- And buying a home with a subprime mortgage, versus refinancing, puts the homeowner at 29 percent greater risk.

The report used Moody's Economy.com housing appreciation forecasts to help us project subprime foreclosure rates in every metropolitan statistical area in the United States. Our research shows that local markets with high housing appreciation in recent years have protected the market from the consequences of these risky and poorly underwritten loans. Consequently, as housing prices slow or reverse, those areas are likely to experience marked increases in subprime foreclosure rates.[8]

A full copy of the "Losing Ground" foreclosure study appears on CRL's website at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189. In addition, we include information on the disparate impacts of these foreclosures in Appendix B.

II. Factors Driving Foreclosures in the Subprime Market

A. Risky Products: 2/28 "Exploding" ARMs

Subprime lenders have been routinely marketing the highest-risk loans to the most vulnerable families and those who already struggle with debt. Because the subprime market is intended to serve borrowers who have credit problems, one might expect the industry would offer loan products that do not amplify the risk of failure. In fact, the opposite is true. Lenders seek to attract borrowers by offering loans that start with deceptively low monthly payments, even though those payments are certain to increase. As a result, many subprime loans can cause "payment shock," meaning that the homeowner's monthly payment can quickly skyrocket to an unaffordable level.

Unfortunately, payment shock is not unusual, but represents a typical feature that comes with the overwhelming majority of subprime home loans. Today the dominant type of subprime loan is a hybrid mortgage called a "2/28" that effectively operates as a two-year "balloon" loan.[9] This ARM comes with an initial fixed teaser rate for two years, followed by rate adjustments in six-month increments for the remainder of the term of the

loan.[10] Commonly, this interest rate increases by between 1.5 and 3 percentage points at the end of the second year, and such increases are scheduled to occur even if interest rates in the general economy remain constant; in fact, the interest rates on these loans generally can only go up, and can never go down.[11] This type of loan, as well as other similar hybrid ARMs (such as 3/27s) have rightfully earned the name "exploding" ARMs.

One would hope that this type of loan would be offered rarely and judiciously. In fact, hybrid ARMs (2/28s and 3/27s) and hybrid interest-only ARMs have become "the main staples of the subprime sector."[12] Through the second quarter of 2006, hybrid ARMs made up 81 percent of the subprime loans that were packaged as investment securities. That figure is up from 64 percent in 2002.[13]

The risks posed by these loans are magnified further because they are designed to generate refinances. These loans typically begin with a low introductory interest rate that increases sharply after a short period of time (one to three years) and fails to account for escrows for required taxes and insurance. The very design of these loans forces struggling homeowners to refinance to avoid unmanageable increased payments.

While multiple refinances boost volume for lenders, these transactions often provide only temporary relief for families, and almost inevitably lead to a downward financial spiral in which the family sacrifices equity in each transaction. These dangerous subprime hybrid ARM loan products and the ensuing refinances make a high rate of foreclosures not only a risk, but a certainty for far too many families. And the likelihood of foreclosure will only increase as housing prices slow and accumulated equity is no longer available to refinance or sell under duress.

As regulators receive comments on their Statement, some in the industry are likely to argue that consumers demand these types of loans and should carry all the responsibility for receiving unsuitable loan products. Through our experience at Self Help and CRL, we have seen that homeowners with subprime ARMs or other types of risky loans were almost never given a choice of products, but were instead automatically steered to these loans, and were given little or no explanation of the loan's terms. Mortgage brokers and lenders are the experts, and consumers should be able to trust them for sound advice and a suitable loan.

It is not hard to find examples of trust that was betrayed. In a Senate hearing held last month, two homeowners struggling with abusive subprime loans appeared as witnesses before the Banking, Housing and Urban Affairs Committee. In one instance, a widow and mother from North Carolina was told by her broker that her refinance would be a fixed-rate loan with an affordable payment. Instead, she was pressured into accepting an adjustable-rate mortgage that started at 10.4 percent, with an interest rate that can go as high as 16.4 percent. Her monthly payment, which does not include taxes and hazard insurance, requires 86 percent of her monthly income, leaving only $388 a month to support herself and her children. Another witness that appeared at the hearing, a retired administrator who lives on the south side of Chicago, trusted a broker who saddled her with a mortgage with monthly payments that now *exceed* her monthly income.[14]

Recently we informally contacted a few practicing attorneys in North Carolina and asked them to provide examples of inappropriate or unaffordable loans from their cases. In less than 48 hours, we received a number of responses, including the cases briefly described in Appendix C. We also are aware of cases in which the borrower requested a fixed-rate mortgage, but received an ARM instead. The industry itself has acknowledged that borrowers placed in subprime hybrid ARMs could have received fixed-rate loans, and that the rate difference is "commonly in the 50 to 80 basis point range", and often a fixed rate loan can have a lower interest rate and monthly payments than a stated income exploding ARM loan.[15] Thus, the high risk of these exploding ARM loans is unnecessary, as better alternative loans are available.

B. Loose Qualifying Standards and Business Practices

The negative impact of high-risk loans could be greatly reduced if subprime lenders had been carefully screening loan applicants to assess whether the proposed mortgages are affordable. Unfortunately, many subprime lenders have been routinely abdicating the responsibility of underwriting loans in any meaningful way.

Lenders today have a more precise ability than ever before to assess the risk of default on a loan. Lenders and mortgage insurers have long known that some home loans carry an inherently greater risk of foreclosure than others. However, by the industry's own admission, underwriting standards in the subprime market have become extremely loose in recent years, and analysts have cited this laxness as a key driver in foreclosures.[16] Let me describe some of the most common problems:

Not considering payment shock: Lenders who market 2/28s and other hybrid ARMs often do not consider whether the homeowner will be able to pay when the loan's interest rate resets, setting the borrower up for failure. Subprime lenders' public disclosures indicate that most are qualifying borrowers at or near the initial start rate, even when it is clear from the terms of the loan that the interest rate can (and in all likelihood, will) rise significantly, giving the borrower a much higher monthly payment.[17] In fact, it is not uncommon for 2/28 mortgages to be originated with an interest rate four percentage points under the fully-indexed rate. For a loan with an eight percent start rate, a four percentage point increase is tantamount to a 40 percent increase in the monthly principal and interest payment amount.

Failure to escrow: The failure to consider payment shock when underwriting is compounded by the failure to escrow property taxes and hazard insurance.[18] When lenders include escrow funds as part of the borrower's monthly house payment, they ensure that these funds are available when due, and they also make the true cost of the loan more transparent. Responsible lenders have always understood that establishing an escrow account is even more important for lower-income borrowers or those with high debt burdens and less disposable income. Yet, in stark contrast to the prime mortgage market, most subprime lenders make loans based on low monthly payments that do not escrow for taxes or insurance.[19] This deceptive practice gives the borrower the

impression that the payment is affordable when, in fact, there are significant additional costs.

When homeowners are faced with large tax and insurance bills they cannot pay, the original lender or a subprime competitor can benefit by enticing the borrowers to refinance the loan and pay additional fees for their new loan. In contrast, it is common practice in the prime market to escrow taxes and insurance and to consider those costs when looking at debt-to-income and the borrower's ability to repay.[20]

Low/no documentation: Inadequate documentation also compromises a lender's ability to assess the true affordability of a loan. Fitch Ratings, the international ratings firm, recently noted "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector . . .." "Low doc" and "no doc" loans originally were intended for use with the limited category of borrowers who are self-employed or whose incomes are otherwise legitimately not reported on a W-2 tax form, but lenders and brokers have increasingly used these loans to inflate borrower incomes and put the borrower into an unaffordable loan.

Multiple risks in one loan: Regulators have expressed concern about combining multiple risk elements in one loan, stating that "risk-layering features in loans to subprime borrowers may significantly increase risks for both the...[lender] and the borrower."[21] Combining adjustable rates with built-in payment shock, prepayment penalties, and poor underwriting, as many of these loans do, profoundly increases the risk of failure.

C. Broker Abuses and Perverse Incentives

Mortgage brokers are individuals or firms who find customers for lenders and assist with the loan process. Brokers provide a way for mortgage lenders to increase their business without incurring the expense involved with employing sales staff directly. Brokers also play a key role in today's mortgage market: According to the Mortgage Bankers Association, mortgage brokers now originate 45 percent of all mortgages, and 71 percent of subprime loans.[22]

Brokers often determine whether subprime borrowers receive a fair and helpful loan, or whether they end up with a product that is unsuitable and unaffordable. Unfortunately, given the way the current market operates, widespread abuses by mortgage brokers are inevitable.

First, unlike other similar professions, mortgage brokers do not believe they have a fiduciary responsibility to the borrower who employs them. Professionals with fiduciary responsibility are obligated to act in the interests of their customers. Many other professionals already have affirmative obligations to their clients, including real estate agents, securities brokers and attorneys. Buying or refinancing a home is the biggest investment that most families ever make, and particularly in the subprime market, this transaction is often decisive in determining a family's future financial security. The broker has specialized market knowledge that the borrower lacks and relies on. And brokers hold themselves out to borrowers as a trusted adviser for navigating the complex

mortgage market. Yet, in most states, mortgage brokers have no legal responsibility to refrain from selling inappropriate, unaffordable loans, or not to benefit personally at the expense of their borrowers.[23]

Second, the market, as it is structured today, gives brokers strong financial incentives to ignore the best interests of homeowners. Brokers and lenders are focused on feeding investor demand, regardless of how particular products affect individual homeowners. Moreover, because of the way they are compensated, brokers have strong incentives to sell excessively expensive loans.[24]

Experts on mortgage financing have long raised concerns about problems inherent in a market dominated by broker originations. For example, the chairman of the Federal Reserve Board, Ben S. Bernanke, recently noted that placing significant pricing discretion in the hands of financially motivated mortgage brokers in the sales of mortgage products can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws.[25] Similarly, a report issued by Harvard University's Joint Center for Housing Studies, stated, "Having no long term interest in the performance of the loan, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear."[26]

D. The Role of Investors and Ratings Agencies

Lenders sometimes claim that the costs of foreclosing give loan originators adequate incentive to avoid placing borrowers into unsustainable loans, but this has proved false. Lenders have been able to pass off a significant portion of the costs of foreclosure through risk-based pricing, which allows them to offset even high rates of predicted foreclosures by adding increased interest costs. Further, the ability to securitize mortgages and transfer credit risk to investors has significantly removed the risk of volatile upswings in foreclosures from lenders. In other words, high foreclosure rates have simply become a cost of business that is largely passed onto borrowers and sometimes investors.

It is clear that mortgage investors have been a driving force behind the proliferation of abusive loans in the subprime market. Their high demand for these mortgages has encouraged lax underwriting and the marketing of unaffordable loans as lenders sought to fill up their coffers with risky loans. For example, approximately 80 percent of subprime mortgages included in securitizations issued the first nine months of 2006 had an adjustable-rate feature, the majority of which were 2/28s.[27]

Under these circumstances, CRL is among those calling for strong leadership from investors and other Wall Street players. There was a notable example of this recently, when Freddie Mac, one of the largest mortgage investors, announced a new policy to only buy subprime adjustable-rate mortgages (ARMs) -- and mortgage-related securities backed by these subprime loans -- that qualify borrowers at the fully-indexed and fully-amortizing rate. Freddie Mac is implementing this policy to protect future borrowers from the payment shock that could occur when their adjustable rate mortgages increase.

We applaud Freddie Mac's action, and Fannie Mae should follow suit by refusing to buy securities backed by high-risk subprime loans that hurt consumers and reverse the benefits of homeownership. The GSEs, with their public mission, should not be permitted to purchase loans to distressed or minority or low-to-moderate income families that do not meet an "ability to repay" standard.

Recently, as foreclosure rates have sharply increased, investors are looking more closely at underwriting practices that have produced foreclosure rates far higher than predicted. While the recent turmoil in the subprime market may force lenders to make some adjustments to accommodate investor concerns, it will not help those borrowers who are in 2/28s now, many of whom will lose their homes, their equity and their credit ratings when lenders foreclose on loans that never should have been made.

E. Federal Neglect

When Congress passed HOEPA in 1994, subprime loans made up only a very small share of the total mortgage market, and predatory lending practices were not nearly as prevalent as they were to become a few years later. It would have been helpful to update HOEPA to keep pace with the rashes of innovative predatory lending practices that occurred after the law passed, but with the pace of change in the mortgage market and the challenges of passing major legislation, that has not been—and never will be—feasible.

On the federal level, one regulatory agency was required to take action: the Federal Reserve Board. The Board's primary authority comes through HOEPA, which requires the Board to prohibit unfair or deceptive mortgage lending practices and to address abusive refinancing practices. Specifically, the Act includes these provisions:

> (l) DISCRETIONARY REGULATORY AUTHORITY OF BOARD.--
> (2) PROHIBITIONS.--The Board, by regulation or order, shall prohibit acts or practices in connection with--
> (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
> (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.[28]

While HOEPA generally applies to a narrow class of mortgage loans, it is important to note that Congress granted the authority cited above to the Board for all mortgage loans, not only loans governed by HOEPA (closed end refinance transactions) that meet the definition of "high cost." Each of the substantive limitations that HOEPA imposes refers specifically to high-cost mortgages.[29] By contrast, the authority granted by subsection (l) refers to "mortgage loans" generally.[30]

The legislative history makes clear that the Board's authority holds for all mortgage loans. The HOEPA bill that passed the Senate on March 17, 1994, and the accompanying Senate report, limited the Board's authority to prohibit abusive practices in connection with high-cost mortgages alone.[31] However, this bill was amended so that the bill that

ultimately passed both chambers, as cited above, removed the high-cost-only limitation, and the Conference Report similarly removed this restriction.[32] The Conference Report also urged the Board to protect consumers, particularly refinance mortgage borrowers.[33]

In fact, the Board itself has acknowledged that it has broad authority to address abusive lending practices on any mortgage loan. In 2001, when the Board was considering amendments to HOEPA, it published a proposed rule and commentary in the Federal Register that included this passage (original emphasis added by the Board):

> Section 129(*l*) of TIL [Truth in Lending] authorizes the Board to prohibit acts or practices to curb abusive lending practices. The act provides that the Board shall prohibit practices: (1) In connection with *all mortgage loans* if the Board finds the practice to be unfair, deceptive, or designed to evade HOEPA: and (2) in connection with *refinancings of mortgage loans* if the Board finds that the practice is associated with abusive lending practices or otherwise not in the interest of the borrower.[34]

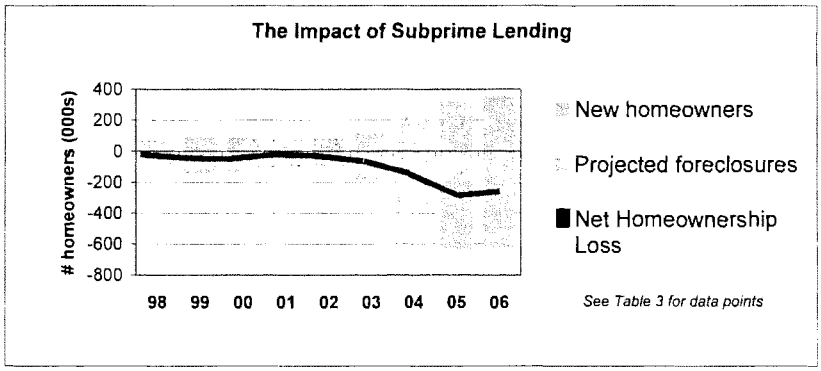
Unfortunately, although the Board has this affirmative duty under TIL accompanied with a broad authority to prohibit acts and practices, and it has publicly affirmed that it applies to all home loans, the Board has not applied that authority in any meaningful fashion.[35] This point was emphasized just last week in a Senate Banking hearing, where Roger Cole, the Board's director of banking supervision, admitted that the Board has failed to act promptly to address the crisis in subprime lending. Mr. Cole said, "Given what we know now, yes, we could have done more sooner."[36] In the same hearing, an official from the FDIC agreed that the current home losses will certainly get worse.[37]

III. The Results: Net Losership

Taken together, all the factors I just discussed have converged to create a "perfect storm" of foreclosures. Industry representatives have often asserted that a higher rate of foreclosures is the price to pay for expanded homeownership. Unfortunately, subprime lending has not resulted in any net gain in homeownership; in fact, there has been a loss.

Over the past nine years, the subprime market has produced more than two trillion dollars in home loans, but only a relatively small portion of these loans have supported first-time ownership—the majority of subprime loans are refinances. Between 1998 and 2006, only an estimated 1.4 million first-time home buyers purchased their home with a subprime loan.[38] Yet over that same time period, there have been many more foreclosures on all subprime loans. In our recent research on subprime foreclosures, CRL estimated that over 2.2 million borrowers who obtained subprime loans will lose or have already lost their home to foreclosure. When we update the analysis to include subprime originations for fourth quarter 2006, the total number of projected subprime foreclosures increases to 2.4 million.[39]

That means that since 1998, subprime lending has led to a net loss of homeownership for almost one million families. In fact, as shown in the following chart, a net homeownership loss occurs in subprime loans made in every one of the past nine years.[40]



These results are not surprising given the high rate of foreclosures in the subprime market combined with the high rate of refinances. Until the recent boom in housing prices, the great majority of subprime loans were refinances.[41] Even in 2006, subprime refinance loans accounted for more than half (56 percent) of all subprime loans made. These loans, obviously, do not contribute to new homeownership. Additionally, a significant proportion of subprime purchase mortgages are obtained by existing homeowners buying another home, not first-time homebuyers.[42] Again, this does not increase homeownership levels. **We estimate that overall since 1998, only nine percent of subprime loans have gone to first-time homebuyers and hence led to increased homeownership (Table 1).**

Table 1: Estimated New Homeownership from Subprime Lending

	Total Subprime Loans Originated[43]	Subprime Loans Used for Home Purchases		Estimated Subprime Loans to First-Time Homebuyers[44] (Homeownership Gain)	
		Number	% of all SP Loans	Number	% of all SP Loans
1998	962,273	293,012	30%	73,253	8%
1999	1,132,280	357,234	31%	89,309	8%
2000	911,369	350,604	38%	87,651	10%
2001	918,557	323,424	35%	80,856	9%
2002	1,046,072	343,530	33%	85,883	8%
2003	1,505,854	483,229	32%	120,807	8%
2004	2,219,547	876,721	40%	219,180	10%
2005	3,259,908	1,297,443	40%	324,361	10%
2006	3,219,749	1,416,690	44%	354,172	11%
TOTAL 98-06	**15,175,609**	**5,741,887**	**38%**	**1,435,472**	**9%**

Second, as discussed earlier, a sizeable percentage of subprime loans end in foreclosure—a much higher proportion than prime loans. **We estimate that 15.6 percent of all subprime loans originated since 1998 either have ended or will end in foreclosure and the loss of homeownership.** These statistics include homeowners who bought their homes with prime loans, but lost their home through abusive subprime refinance loans.

Table 2: Estimated Lost Homeownership from Subprime Lending

	Total Subprime Loans Originated	Projected Subprime Foreclosures [45] (Homeownership Loss)	Projected Cumulative Foreclosure Rate[46]
1998	962,273	94,750	9.8%
1999	1,132,280	144,567	12.8%
2000	911,369	133,126	14.6%
2001	918,557	105,464	11.5%
2002	1,046,072	102,252	9.8%
2003	1,505,854	181,464	12.1%
2004	2,219,547	348,345	15.7%
2005	3,259,908	632,302	19.4%
2006	3,219,749	624,631	19.4%
TOTAL 98-06	**15,175,609**	**2,366,901**	**15.6%**
CRL original foreclosure projection based on 2006 statistics for 1Q-3Q only[47]	*14,446,135*	*2,225,442*	*15.4%*

Comparing the homeownership gain from subprime lending to first-time homebuyers (Table 1) to the loss of homes caused by subprime foreclosures (Table 2), we see a net loss of homeownership every year since 1998, totaling almost one million families.

Table 3: Net Impact on Homeownership from Subprime Lending

	Estimated Subprime Loans to First-Time Homebuyers (Homeownership Gain)	Projected Subprime Foreclosures (Homeownership Loss)	Net Homeownership Gain or (Loss)
1998	73,253	94,750	(21,497)
1999	89,309	144,567	(55,258)
2000	87,651	133,126	(45,475)
2001	80,856	105,464	(24,608)
2002	85,883	102,252	(16,369)
2003	120,807	181,464	(60,657)
2004	219,180	348,345	(129,165)
2005	324,361	632,302	(307,941)
2006	354,172	624,631	(270,459)
TOTAL 98-06	**1,435,472**	**2,366,901**	**(931,429)**

Lost Homeownership for African Americans and Latinos

Subprime lenders frequently assert that subprime loans have been a boon for African-American and Latino families in particular, but that's not the case: Both populations also experienced a net loss of homeownership due to these loans.

Table 4. Impact of 2005 Subprime Lending on Homeownership by Race/Ethnicity

	African-Americans	Latinos	Other Borrowers
2005 Subprime Originations[48]	505,286	570,484	2,244,617
Number of Subprime Loans to First-Time Homebuyers (Homeownership Gain)	50,925	72,981	200,455
Projected Foreclosures on 2005 Subprime Loans (Homeownership Loss)[49]	98,025	110,674	423,723
Net Homeownership Gain or (Loss)	**(47,101)**	**(37,693)**	**(308,061)**

The implications of this analysis are even more disturbing in light of the difficulties of recovering from a foreclosure. Research indicates that homeowners who give up homeownership for any reason can take more than a decade to become homeowners again—and even longer for minorities.[50] Thus, the massive foreclosures resulting from subprime lending not only represent a loss of immediate opportunity for wealth-building, but also a lost opportunity that can carry forward for many years.

IV. Solutions

Congress has a long history of strong policies to support homeownership, but that task has become more complicated than ever. Supporting homeownership continues to involve encouraging fair lending and fair access to loans. But supporting homeownership also means refusing to support loans that are abusive, destructive and unnecessarily risky.

A few years ago, the problem of subprime foreclosures likely would have received scant attention from policymakers, since subprime mortgages represented only a small fraction of the total mortgage market. Today subprime mortgages comprise almost one quarter of all mortgage originations. The merits of this expanding market are widely debated, but one point is clear: Subprime mortgage credit—and the accompanying foreclosures—have become a major force in determining how and whether many American families will attain sustainable wealth. This is particularly true in urban areas, where wealth-building is a critical issue.

There are simple, known solutions to help preserve the traditional benefits of homeownership and to address many of the problems I have mentioned today. Here I discuss our recommendations:

1. Restore safety to the subprime market by imposing a borrower "ability to repay" standard for all subprime loans. The federal banking and credit union regulators should adopt the proposed Statement that calls on federally regulated banking institutions to make sure lenders underwrite loans to the fully indexed, fully amortizing rate. We also recommend that they require that lenders escrow for property taxes and hazard insurance on subprime loans. Further, the Statement points out the problems with no-doc loans, and the final Statement should affirmatively require that lenders verify and document all sources of income using either tax or payroll records, bank account statements or other reasonable third-party verification.

2. Require the Federal Reserve to act, or address abuses through the FTC. HOEPA, the major federal law designed to protect consumers against predatory mortgage lending, has manifestly failed to stem the explosion of harmful lending abuses that has accompanied the recent subprime lending boom. In HOEPA, Congress required the Federal Reserve Board to address these problems for all mortgage loans, but to date the Board has not done so. It should do so now. Given the Board's record, Congress should seriously consider also enlisting the Federal Trade Commission's assistance in addressing abuses that have gone on too long.

3. Require government-sponsored enterprises to stop investing in abusive subprime loan securities. Currently Fannie Mae is purchasing mortgage-backed securities that include high-risk subprime loans. Providing liquidity to lenders who market abusive, high-risk loans that are not truly affordable is clearly counter to its mission. Fannie Mae should follow Freddie Mac's lead and voluntarily stop investing in these securities. In addition, HUD should stop giving them affordable goals credit for purchasing these AAA securities (take them out of both the numerator and denominator in assessing the market), and OFHEO should prohibit the agencies from adding these securities to their portfolios.

4. Hold industry players accountable for their actions. Lenders, brokers, servicers, investors and trustees should stem the tide of foreclosures by proactively modifying loans to make them sustainable. There is no longer any dispute that brokers and lenders have placed borrowers into loans that set them up for foreclosures, and the secondary market provided key support and high demand for this reckless lending. The parties who enabled this crisis should be held fully accountable for minimizing the damage today by taking a proactive role in changing the terms of 2/28s and other abusive subprime loans. Specific remedies will vary depending on the homeowner's situation, but examples of positive actions include converting loans to fixed-rate mortgages with affordable interest rates, writing down principal loan balances, and waiving prepayment penalties.

Brokers are involved in 70 percent of subprime originations, but perverse economic incentives encourage brokers to act counter to the interests of the borrowers and allow lenders to look the other way. One necessary step is to make lenders liable for all acts and omissions of the brokers that occur while the brokers are placing people in abusive loans.

These responsibilities should continue along the lending chain. To preserve homeownership, the trustees representing these nameless, faceless secondary market investors should be required to answer for the transgressions of the brokers, lenders and servicers of the loans that form mortgage-backed securities. The bottom line is that victims of abusive practices should be able to fight to stay in their homes, and the brokers and lenders should not be able to hide behind the secondary market, nor should the secondary market be able to hide behind the holder in due course rule to literally leave borrowers out in the cold.

5. Strengthen existing bankruptcy law to assist homeowners harmed by subprime foreclosures. Currently many struggling borrowers have no chance for recovery except through bankruptcy. The problem is that as currently enacted, the Bankruptcy Code favors home mortgage lenders over all other secured and unsecured creditors. Written at a time when home mortgages were nearly all fixed-interest rate instruments with low loan-to-value ratios and were rarely the source of a family's financial distress, bankruptcy law singles out the home mortgage loan as the one debt for which the bankruptcy court is powerless to provide relief. Since that time, the mortgage market has shifted considerably. Subprime lending practices of the last six years, which have relied on property appreciation, and in many cases appraisal fraud, have left many borrowers with mortgages larger than the value of their homes. If these homeowners cannot restructure these debts, then they cannot get back on their feet financially. For this reason, a modification to the bankruptcy code is necessary and appropriate.

6. Strengthen protections against destructive home lending by passing a new national anti-predatory lending bill. Federal law has clearly not kept up with the abuses in the changing mortgage market. HOEPA needs to be extended and updated to address the issues that are driving foreclosures today. Even should this happen, we need to realize that it is impossible for any single law to cover all contingencies or to anticipate predatory practices that will emerge in the future. Any new federal law must therefore preserve the right of the states to supplement the law, when necessary, to address new or locally-focused lending issues. While HOEPA is weak, it did recognize the limits of federal law, and therefore functions as a floor, not a ceiling. If HOEPA had not allowed states to take action, today's disastrous levels of foreclosures would be even worse.

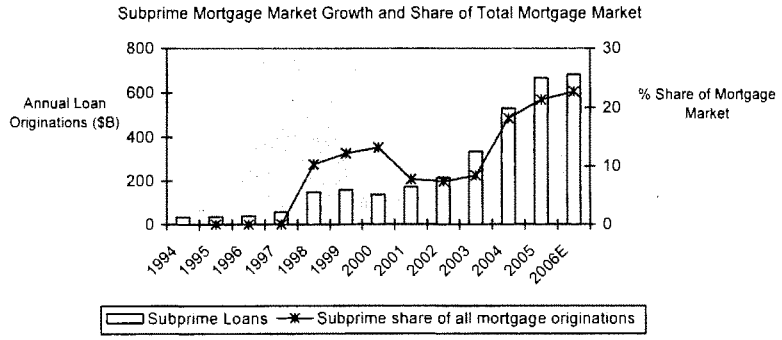
Thank you very much for the opportunity to testify before you today. I would be happy to answer any questions you may have.

APPENDIX A

Background on the Subprime Market and the Evolution of Predatory Lending[51]

The subprime market is intended to provide home loans for people with impaired or limited credit histories. In addition to lower incomes and blemished credit, borrowers who get subprime loans may have unstable income, savings, or employment, and a high level of debt relative to their income.[52] However, there is evidence that many families—a Freddie Mac researcher reports one out of five—who receive subprime mortgages could qualify for prime loans, but are instead "steered" into accepting higher-cost subprime loans.[53]

As shown in the figure below, in a short period of time subprime mortgages have grown from a small niche market to a major component of home financing. From 1994 to 2005, the subprime home loan market grew from $35 billion to $665 billion, and is on pace to match 2005's record level in 2006. By 2006, the subprime share of total mortgage originations reached 23 percent.[54] Over most of this period, the majority of subprime loans have been refinances rather than purchase mortgages to buy homes. Subprime loans are also characterized by higher interest rates and fees than prime loans, and are more likely to include prepayment penalties and broker kickbacks (known as "yield-spread premiums," or YSPs).



Source: Inside Mortgage Finance

When widespread abusive lending practices in the subprime market initially emerged during the late 1990s, the primary problems involved equity stripping—that is, charging homeowners exorbitant fees or selling unnecessary products on refinanced mortgages, such as single-premium credit insurance. By financing these charges as part of the new loan, unscrupulous lenders were able to disguise excessive costs. To make matters

worse, these loans typically came with costly and abusive prepayment penalties, meaning that when homeowners realized they qualified for a better mortgage, they had to pay thousands of dollars before getting out of the abusive loan.[55]

In recent years, when the federal government failed to act, a number of states moved forward to pass laws that address equity-stripping practices. Research assessing these laws has shown them to be highly successful in cutting excessive costs for consumers without hindering access to credit.[56] The market has expanded at an enormous rate during recent years even while states reported fewer abuses targeted by new laws.

APPENDIX B
Disparate Impacts of Foreclosures

The costs of subprime foreclosures are falling heavily on African-American and Latino homeowners, since subprime mortgages are disproportionately made in communities of color. The most recent lending data submitted under the Home Mortgage Disclosure Act (HMDA) show that over half of loans to African-American borrowers were higher-cost loans, a measurement that serves as a proxy for subprime status.[57] For Latino homeowners, the portion of higher-cost loans is also very high, at four in ten. The specific figures are shown below:

Share of Higher Cost Mortgages by Race
Based on 2005 Data Submitted Under the Home Mortgage Disclosure Act

Group	No. of Higher-Cost Loans	% for Group	% of Total
African American	388,741	52%	20
Latino	375,889	40%	19
White	1,214,003	19%	61

Given the projected foreclosure rate of approximately one-third of borrowers taking subprime loans in recent years, this means that subprime foreclosures could result in the loss of a home for approximately 12 percent of all recent Latino mortgage borrowers and 16 percent of African-American borrowers. If this comes to pass, it is potentially the biggest loss of African-American wealth in American history.

However, while the negative impact of foreclosures falls disproportionately on communities of color, the problem is not confined to any one group. In absolute terms, white homeowners received three times as many higher-cost mortgages as African-American borrowers, and therefore will experience a significant number of foreclosures as well.

APPENDIX C

To illustrate the unfortunate realities of inappropriate and unaffordable 2/28 adjustable rate mortgages (ARMs), recently the North Carolina Justice Center informally contacted a few practicing attorneys in North Carolina to provide examples from their cases. They received a number of responses, including these described below.

1. **From affordable loan to escalating ARM .**
   Through a local affordable housing program, a homeowner had a 7% fixed-rate, 30-year mortgage. A mortgage broker told the homeowner he could get a new loan at a rate "a lot" lower. Broker originated a 2/28 ARM with a starting rate of 6.75%, but told borrower that it was a fixed-rate, 30-year mortgage. At the 24th month, the loan went up to 9.75%, following the loan's formula of LIBOR plus 5.125% and a first-change cap maximum of 9.75%. Loan can go up to a maximum of one point every six months, with a 12.75% total cap. Now borrower cannot afford the loan and faces foreclosure.

2. **Temporary lower payments—a prelude to shock.**
   Homeowner refinanced out of a fixed-rate mortgage because she wanted a lower monthly payment. The homeowner expressly requested lower monthly payments that included escrow for insurance and taxes. Mortgage broker assured her that he would abide by her wishes. Borrower ended up in a $72,000 2/28 ARM loan with first two years monthly payments of $560.00 at a rate of 8.625%. This initial payment was lower than her fixed-rate mortgage, but it did not include escrowed insurance and taxes. After two years, loan payments increased every six months at a maximum one percent with a cap of 14.625%. At the time of foreclosure, the interest rate had climbed to 13.375% with a monthly payment $808.75. If the loan had reached its maximum interest rate, the estimated monthly payment would be close to $900.00.

3. **Unaffordable from the start.**
   Homeowner had a monthly payment of $625 and sought help from a mortgage broker to lower monthly payment. Broker initially said he could lower the payment, but before closing said the best he could do was roughly $800. He assured borrower that he could refinance her to a loan with a better payment in six months. Previously he had advised homeowner not to pay her current mortgage payment because the new loan would close before the next payment due date. In fact, closing occurred after the payment was due, and borrower felt she had to close. Loan was a 2/28 ARM with an initial interest rate of 11% and a ceiling of 18% at an initial monthly payment of $921. Interest at first change date is calculated at LIBOR plus 7%, with a 12.5% cap and a 1.5% allowable increase/decrease at each 6-month change date. First change date is June 1, 2008. By approximately the third payment, however, borrower could not afford mortgage payments and is now in default.

End Notes

[1] Mortgage Finance Industry Overview, Lehman Brothers Equity Research (December 22, 2006). From page 1: "Lehman's fixed income trading and research teams expect the prime markets to experience an orderly consolidation as loan volume, gain on sale margins and credit quality revert to 'normal' less robust levels in 2007. However, they are very cautious on subprime, projecting 30% losses over time on the 2006 vintage."

[2] *See* 72 Fed. Reg. 10533 (March 8, 2007) for the federal Interagency Proposed Statement on Subprime Mortgage Lending issued by the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Department of the Treasury and the National Credit Union Administration.

[3] *See* 72 Fed. Reg. 10533 (March 8, 2007) at 7-8, setting the following standard: "Prudent qualifying standards recognize the potential effect of payment shock in evaluating a borrower's ability to service debt. An institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. ...This assessment is particularly important if the institution relies upon reduced documentation or allows other forms of risk layering."

[4] The Conference of State Banking Supervisors and the American Association of Residential Mortgage Regulators (AARMR) have issued a statement that they intend to issue draft model guidance for state regulators which will mirror the Federal regulators' Statement. We hope that each state will enact guidance that directs lenders to consider ability to repay before extending any home loan.

[5] The rate of new foreclosures as a percent of all loans rose from 0.13 in 1980 to 0.42 in 2005, as reported in the *National Delinquency Survey,* Mortgage Bankers Association. 2005 new foreclosure filings statistic from Realty Trac in *Home Foreclosures on the Rise,* MoneyNews (February 23, 2006) at http://www.newsmax.com/archives/articles/2006/2/23/134928.shtml.

[6] "More Than 1.2 Million Foreclosures Reported in 2006 According to RealtyTrac™ U.S. Foreclosure Market Report (January 25, 2007) http://biz.yahoo.com/prnews/070125/lath048.html?.v=87.

[7] See, e.g., Saskia Scholtes, Michael Mackenzie and David Wighton, "US Subprime Loans Face Trouble," *Financial Times* (December 7, 2006); "Nightmare Mortgages," *Business Week* (September 11, 2006); Vikas Bajaj and Christine Haughney, "Tremors at the Door, *New York Times* (January 26, 2007); Matthew Padilla, "Subprime's Grip Slips," *The Orange County Register* (January 28, 2997); and "Vikas Bajaj "For Some Subprime Borrowers, Few Good Choices," *New York Times* (March 22, 2007).

[8] As one example, in the greater Washington, D.C. area, projected lifetime foreclosure rates on subprime loans made from 1998 through 2001 are slightly over eight percent, but for subprime mortgages made in 2006, the projected foreclosure rate shoots up to nearly 23 percent.

[9] A balloon loan is one that is not repayable in regular monthly installments, but rather requires repayment of the remaining balance in one large lump sum. While 2/28s are not balloon loans, the impact of higher interest rates at the end of the two-year teaser rate period, resulting in higher monthly payments, may force a borrower to seek refinancing.

[10] See, e.g., *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs,* p. 2 Fitch Ratings Credit Policy (August 21, 2006).

[11] Here we are describing the 2/28 because it is by far the most common product in the subprime market, but the concerns are the same with the 3/27, which differs only in that the teaser rate remains in effect for three years.

[12] See, e.g., *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, p. 2 Fitch Ratings Credit Policy (August 21, 2006).

[13] *Structured Finance*, note 12.

[14] "Preserving the American Dream: Predatory Lending Practices and Home Foreclosures," U.S. Senate Committee on Banking, Housing, and Urban Affairs (February 7, 2007), at http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=248.

[15] January 25, 2007 letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3.

[16] See e.g., Office of the Comptroller of the Currency, National Credit Committee, *Survey of Credit Underwriting Practices 2005*.The Office of The Comptroller of Currency (OCC) survey of credit underwriting practices found a "clear trend toward easing of underwriting standards as banks stretch for volume and yield," and the agency commented that "ambitious growth goals in a highly competitive market can create an environment that fosters imprudent credit decisions." In fact, 28% of the banks eased standards, leading the 2005 OCC survey to be its first survey where examiners "reported net easing of retail underwriting standards." *See also* Fitch Ratings, 2007 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis (December 11, 2006).

[17] For example, Fremont considered ability to repay based on initial payments due during the first year. Fremont Investment and Loan Prospectus, Fremont Home Loan Trust 2006-1 424B5 (April 4, 2006) available at: http://www.sec.gov/Archives/edgar/data/1357374/000088237706001254/d486451_all.htm. Option One qualified borrowers at the initial teaser rate. See Option One Prospectus, Option One Mortgage Loan Trust 2006-3 424B5 (October 19, 2006) http://www.sec.gov/Archives/edgar/data/1378102/000088237706003670/d581063_424b5.htm Fremont Investment and Loan Prospectus, Fremont Home Loan Trust 2006-1 424B5 (April 4, 2006), http://www.sec.gov/Archives/edgar/data/1357374/000088237706001254/d486451_all.htm, Morgan Stanley Prospectus, Morgan Stanley ABS Capital I Inc. Trust 2007-NC1 Free Writing Prospectus (January 19, 2007), http://www.sec.gov/Archives/edgar/data/1385136/000088237707000094/d609032_fwp.htm. Likewise, New Century's strongest underwriting practice, which is applied only to borrowers with a credit score under 580 and a loan-to-value ratio over 80 percent, is to evaluate the borrower's ability to repay the mortgage at an interest rate equal to the fully indexed rate minus one percentage point. "Best Practices Won't Kill Production at New Century," p. 3 *Inside B&C Lending* (November 24, 2006).

[18] See, e.g., "B&C Escrow Rate Called Low," *Mortgage Servicing News Bulletin* (February 23, 2005), "Servicers of subprime mortgage loans face a perplexing conundrum: only about a quarter of the loans include escrow accounts to ensure payment of insurance premiums and property taxes, yet subprime borrowers are the least likely to save money to make such payments... Nigel Brazier, senior vice president for business development and strategic initiatives at Select Portfolio Servicing, said only about 25% of the loans in his company's subprime portfolio have escrow accounts. He said that is typical for the subprime industry."

[19] See, e.g., "Attractive Underwriting Niches," Chase Home Finance Subprime Lending marketing flier, at http://www.chaseb2b.com/content/portal/pdf/subprimeflyers/Subprime_AUN.pdf (available 9/18/2006) stating, " Taxes and Insurance Escrows are NOT required at any LTV, and there's NO rate add!", (suggesting that failing to escrow taxes is an "underwriting highlight" that is beneficial to the borrower). 'Low balling' payments by omitting tax and insurance costs were also alleged in states' actions against Ameriquest. *See, e.g.* State of Iowa, ex rel Miller v. Ameriquest Mortgage Co. et al, Eq. No. EQCE-53090 Petition, at ¶ 16(B) (March 21, 2006).

[20] In fact, Fannie Mae and Freddie Mac, the major mortgage investors, require lenders to escrow taxes and insurance.

[21] See 71 Fed. Reg. 58609 (October 4, 2006) for the federal Interagency Guidance on Nontraditional Mortgage Product Risks, issued by the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Department of the Treasury and the National Credit Union Administration.; *See also See* 72 Fed. Reg. 10533 (March 8, 2007) at 7-8, stating that prudent underwriting, attention to the potential impact of payment shock and proper consideration of a borrower's ability to repay are "particularly important if the institution relies upon reduced documentation or allows other forms of risk layering."

[22] MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006.

[23] About one-third of the states have established, through regulation or case law, a broker's fiduciary duty to represent borrowers' best interests. However, many of these provisions are riddled with loopholes and provide scant protection for borrowers involved in transactions with mortgage brokers.

[24] Brokers earn money through up-front fees, not ongoing loan payments. To make matters worse for homeowners, brokers typically have a direct incentive to hike interest rates higher than warranted by the risk of loans. In the majority of subprime transactions, brokers demand a kickback from lenders (known as "yield spread premiums") if they deliver mortgages with rates higher than the lender would otherwise accept. Not all loans with yield-spread premiums are abusive, but because they have become so common, and because they are easy to hide or downplay in loan transactions, unscrupulous brokers can make excessive profits without adding any real value.

[25] Remarks by Federal Reserve Board Chairman Ben S. Bernanke at the Opportunity Finance Network's Annual Conference, Washington, D.C. (November 1, 2006).

[26] Joint Center for Housing Studies, "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," Harvard University at 4-5. Moreover, broker-originated loans "are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors." Id. at 42 (citing Alexander 2003).

[27] *Inside B&C Lending,* Inside Mortgage Finance, p. 2 (November 24, 2006).

[28] 15 USC Section 1639(l)(2). Emphasis added.

[29] These limitations concern certain prepayment penalties, post-default interest rates, balloon payments, negative amortization, prepaid payments, ability to pay, and home improvement contracts. See subsections 129(c)-(i). High cost mortgages are those "referred to in section 103(aa)."

[30] Most subprime abuses occur with refinance loans rather than loans used to purchase a house (what HOEPA calls a "residential mortgage transaction", Sec. 152(aa)(1)). HOEPA's enumerated protections are limited to closed end refinance loans that meet the high cost standard. However, section (l) refers to "mortgage loans" generally, which would include purchase-money loans. The fact that section (l)(2) prohibitions are directed at two separate types of loans -- (A) those the Board finds to be unfair, deceptive, or designed to evade HOEPA, and (B) abusive refinancings -- provides evidence that subsection (A) includes purchase money loans as well.

[31] See S.1275, Section 129(i)(2): "PROHIBITIONS--The Board, by regulation or order, shall prohibit any specific acts or practices in connection with high cost mortgages that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section." Reported in 140 Cong. Rec. 3020, S3026. According to the Senate Report, No. 103-169, p. 27, "the legislation requires the Federal Reserve Board to prohibit acts or practices in connection with High Cost Mortgages that it finds to be unfair, deceptive, or designed to evade the provisions of this section."

[32] See House Conf. Rep. No. 103-652, p. 161, "the Board is required to prohibit acts and practices that it finds to be unfair, deceptive, or designed to evade the section and with regard to refinancing that it finds to be associated with abusive lending practices or otherwise not in the interest of the borrower."

[33] "The Conferees recognize that new products and practices may be developed to facilitate reverse redlining or to evade the restrictions of this legislation. Since consumers are unlikely to complain directly to the Board, the Board should consult with its Consumer Advisory Council, consumer representatives, lenders, state attorneys general, and the Federal Trade Commission, which has jurisdiction over many of the entities making the mortgages covered by this legislation.

"This subsection also authorizes the Board to prohibit abusive acts or practices in connection with refinancings. Both the Senate and House Banking Committees heard testimony concerning the use of refinancing as a tool to take advantage of unsophisticated borrowers. Loans were "flipped" repeatedly, spiraling up the loan balance and generating fee income through the prepayment penalties on the original loan and fees on the new loan. Such practices may be appropriate matters for regulation under this subsection." Id.

[34] 66 Fed. Reg. 65604, 65612 (December 20, 2001).

[35] The Board did cite section 129(*l*) during its rulemaking process in 2001-02 (including rules on due-on-sale clauses and evasion of HOEPA using open-end loans, although it appears that the authority to issue rules to prohibit evasion of HOEPA is independent); however, it did not propose any prohibitions of acts and practices that would apply to all home loans.

[36] Greg Hitt and James R. Hagerty, "Regulators are Pressed to Take Tougher Stand on Mortgages," *Wall Street Journal* (March 23, 2007).

[37] Hitt and Hagerty, note 36.

[38] In this analysis we set aside the fact that many of these borrowers could have received a more sustainable, conventional loan instead. A Freddie Mac researcher estimates 20 percent ("More Homeowners with Good Credit Getting Stuck with Higher-Rate Loans," *Los Angeles Times* [Oct. 24, 2005]), and others could have qualified for Federal Housing Administration loans.

[39] All figures in this analysis cover only loans to owner-occupants in the 50 states and the District of Columbia secured by a first-lien on a single-family home, condominium, townhouse, or a unit in a planned development. 1998-2004 figured derived from a proprietary database of subprime loans sold in the secondary mortgage market between 1998 and 2004. We modified 2005-2006 estimates from *Inside Mortgage Finance* and SMR Research Corporation to account for these criteria.

[40] Our numbers are conservative for two reasons. First, the proprietary database used consists of loans sold on the secondary market, and contains a higher proportion of subprime loans for home purchase than the overall subprime market. Second, the foreclosure projections were developed by CRL for its recent study *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowner (see full cite in note 46)*, and are based on conservative assumptions. Since that report was published in December 2006, other analyses suggest that foreclosures in the subprime market could actually be higher than CRL's projections. See, e.g., Lehman Brothers projects 30% losses over time for subprime loans originated in 2006 (*Mortgage Finance Industry Overview*, p. 4. Lehman Brothers Equity Research. December 22, 2006). If Lehman Brothers' foreclosure projections for 2006 are incorporated with CRL's projections for prior years, the total number of subprime foreclosures originated 1998-2006 climbs to 2.7 million households.

[41] Percent of subprime loans used for home purchase versus refinance were derived from the proprietary database for 1998-2004, and from SMR Research Corp and Inside Mortgage Finance for 2005-2006. The specific percentages by year are shown below. Totals may not add to 100% because a small percentage of loans in the database are listed as "other purpose"

	1998	1999	2000	2001	2002	2003	2004	2005	2006
% Subprime 'Refinance	67.2	66.9	60.4	64.8	67.1	67.9	60.5	60.0	56.0
% Subprime Purchase	30.5	31.6	38.5	35.2	32.8	32.1	39.5	40.0	44.0

[42] Douglas Duncan of the Mortgage Bankers Association testified on February 27, 2007 before the U.S. Senate Committee on Banking, Housing, & Urban Affairs that approximately 25% of subprime loans in 2006 were used by first-time homebuyers. See p. 5 at http://banking.senate.gov/_files/duncan.pdf.

[43] See note 39 for information on the source of these numbers.

[44] Our analysis applied the percentage of loans to first-time homebuyers cited by the MBA (25% --see Note 4) was applied consistently to all years 1998-2006. We believe this is a conservative approach, as the percentage of first-time homebuyers served in earlier years was probably below this figure.

[45] Ibid. Page 16. 2006 statistics have been adjusted upward to reflect inclusion of 4th quarter 2006 numbers, which were not included in original report published December 2006.

[46] Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending at 22 (December 2006), available at www.responsiblelending.org.

[47] See *Losing Ground,* note 46, Table 6 - p. 16.

[48] HMDA statistics for the total market are slightly lower than statistics shown in Tables 1 & 2, because not all subprime lenders are required to report under HMDA regulations.

[49] Assumes a 19.4% foreclosure rate as calculated for all 2005 subprime originations—see Table 2. This is a conservative estimate, as communities of color receive a disproportionate share of subprime loans, and the clustering of foreclosures in these markets is likely to cause a "feedback loop" that further depresses home values in the market and spurs additional foreclosures.

[50] Donald R. Haurin and Stuart S. Rosenthal, "The Sustainability of Homeownership: Factors Affecting the Duration of Homeownership and Rental Spells," HUD Office of Policy Development and Research at p. 43 (December 2004), available at http://www.huduser.org/Publications/pdf/homeownersustainability.pdf.

[51] Much of the following material originally appeared in the "Losing Ground" report cited in note 5.

[52] Ira Goldstein, *Bringing Subprime Mortgages to Market and the Effects on Lower-Income Borrowers,* p.2 Joint Center for Housing Studies, Harvard University (February 2004) at http://www.jchs.harvard.edu/publications/finance/babc/babc_04-7.pdf.

[53] Mike Hudson and E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans*, L.A. Times, p. A-1 (October 24, 2005). For most types of subprime loans, African-Americans and Latino borrowers are more likely to be given a higher- cost loan even after controlling for legitimate risk factors. Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending, (May 31, 2006) at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=29371010; *See also* Darryl E. Getter, *Consumer Credit Risk and Pricing*, Journal of Consumer Affairs (June 22, 2006); Howard Lax, Michael Manti, Paul Raca, Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 533, 562, 569, Housing Policy Debate 15(3) (2004).

[54] "Subprime Mortgage Origination Indicators," *Inside B&C Lending* (November 10, 2006).

[55] See, e.g., Eric Stein, *Quantifying the Economic Costs of Predatory Lending*, Center for Responsible Lending (2001).

[56] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, Housing Policy Debate, (15)(3): (2004); Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms* (2006) *available at* http://www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf.

[57] The Home Mortgage Disclosure Act requires most lenders to file annual reports containing specified information about the "higher-cost loans" they originated. "Higher-cost loans" are those for which the APR exceeds the rate on a Treasury security of comparable maturity by 3 percentage points for first liens, and 5 percentage points for second liens. FRB analysis of 2005 HMDA data indicates that non-Hispanic whites received over 1.2 million higher-cost loans, compared to 388,471 for African-Americans and 375,889 for Latinos. Authors' calculations from data reported in Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data*, Federal Reserve Bulletin A123, A160-161 (Sept. 8, 2006) http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf.

Testimony of the National Community Reinvestment Coalition

Josh Silver, Vice President of Research and Policy

Before the Subcommittee of the House Financial Services Committee on Financial Institutions and Consumer Credit

Regarding Abusive Mortgage Lending Practices, Exotic Mortgages, and Foreclosures

Tuesday, March 27, 2007

Introduction

Chair Maloney and Ranking Member Gillmor, it is an honor to be here today as the voice for over 600 community organizations from across the country that comprises the National Community Reinvestment Coalition. NCRC is the nation's economic justice trade association dedicated to increasing access to credit and capital for minority and working class families. I testify this morning on behalf of NCRC and John Taylor, President and CEO of NCRC. We appreciate you convening today's hearing on an issue that all of our members have been addressing for the last several years.

Predatory lending is a national epidemic. Abusive lenders have stolen billions of dollars in home equity and have taken thousands of homes in foreclosure proceedings. The abuse is spread throughout the entire transaction process to include appraisal and broker fraud on the front end to abusive servicing and inadequate secondary market due diligence on the back end. On top of the usual predatory traps and tricks, we are now witnessing a surge of exotic mortgage lending such as interest-only mortgages, payment-only Adjustable Rate Mortgages (ARMs), and "hybrid" 2/28 and 3/27 ARMs.

The exotic mortgage lending too often becomes toxic lending when the unsuspecting borrower discovers that the introductory low teaser rates have expired and are replaced by high monthly payments that are no longer affordable. According to the FDIC's testimony at last week's Senate hearing, interest rates are due to rise for borrowers of one million subprime loans in 2007 and another 800,000 next year.[1]

Perceiving profitable opportunities, predatory lenders and unsavory investors have dramatically increased their financing of risky non-traditional lending. According to the Mortgage Bankers Association, 39% of mortgage loans were interest-only or option ARMs in the first six months of 2006 in contrast to 33% in the second half of 2005 and less than 2% in 2000.[2] Low documentation loans have also soared with brokers qualifying consumers that they know should not be qualified. In a recent survey, 43% of brokers using low documentation loans said their borrowers could not qualify under standard debt-to-income ratios, hinting that they used low documentation loans so that they could skirt the usual and careful underwriting.[3]

The upshot of the upswing in dangerous lending is that 223,000 households with subprime loans lost their homes to foreclosure and 725,000 had missed mortgage payments in the third quarter of 2006, according to the Mortgage Bankers Association.[4]

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[1] "Regulators are Pressed to Take Tougher Stand on Mortgages," by Gregg Hitt and James R. Hagerty, Wall Street Journal, March 23, 2007

[2] "Nontraditional Mortgages Don't Wane Under Warnings," Kirsten Downey, Washington Post, Tuesday, October 24, 2006.

[3] "The Lowdown on Low-Doc Loans," Kenneth Harney, appearing in the Washington Post, Saturday, November 25, 2006.

[4] "High-Cost Mortgages Putting Many Homeowners at Risk," Kirsten Downey, Washington Post, Thursday, December 14, 2006.

According to industry sources, defaults in the end of 2006 exceeded the rate in the last recession of 2001. The percentage of subprime mortgages delinquent by 90 days or more, in foreclosure, or resulting in seized properties hit 10% in November of 2006, almost double the 5.4% in spring 2005. According to the FDIC, more than 14% of the $1.28 trillion in outstanding subprime loans were delinquent by the end of 2006.[5]

The surge in dangerous lending threatens an already vulnerable group of consumers and communities. Predatory lenders prey on the working class, minorities, and the elderly. Congress needs to enact a strong national bill that protects American families from abusive lending practices that steal homeowner equity, which is the primary or only form of wealth building for most Americans. The recent regulatory guidance on non-traditional mortgages and proposed guidance on subprime ARM lending is helpful. But the guidance by itself provides incomplete protections as it only applies to a subset of lenders, and is not backed by certain and swift penalties for illegal and abusive lending.

NCRC applauds the recent move by Freddie Mac to adopt the non-traditional guidance and include additional safeguards in its secondary market activities. Yet, Freddie Mac and Fannie Mae have not had the dominant role in financing subprime lending while unregulated secondary market players have significantly stepped up their operations in the subprime market. NCRC agrees with Federal Reserve Chairman Ben Bernanke that a federal anti-predatory is desirable but we assert that policymakers already understand the characteristics of predatory lending and do not have to wait while we further ferret out the differences between predatory and responsible lending as the Federal Reserve Chairman urges. NCRC is also encouraged that FDIC Chairman Sheila Bair suggests that Congress must "seriously consider" a national anti-predatory law that would apply to all lending institutions.[6]

In my testimony today, I am going to describe the national dimensions of the problem. I am going to draw upon NCRC's Consumer Rescue Fund program, which is a national level program that identifies victims of predatory lenders on the brink of foreclosure and bankruptcy, and then arranges affordable refinance loans so that they can remain in their homes. I will also highlight the results from national testing (mystery shopping) of subprime lenders from across the country. Finally, NCRC's data analysis demonstrates that lending disparities are a national phenomena, which is stubborn and persistent. The likelihood of steering and price discrimination is too great for policymakers to ignore. While voluntary best practices may reduce the incidence of steering and abusive lending, the strength of the evidence suggests that a comprehensive national law is necessary.

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[5] "Subprime Defaults at Recession Level, FBR Says," Bloomberg News reproduced in the American Banker, February 5, 2007; "Regulators are Pressed to Take Tougher Stand on Mortgages," by Gregg Hitt and James R. Hagerty, Wall Street Journal, March 23, 2007.

[6] "Bernanke: Predator Bill 'Would be a Good Idea,'' American Banker, Friday, February 16, 2007; Gregg Ip and Damian Paletta, "Lending Oversight: Regulators Scrutinized in Mortgage Meltdown," March 22, 2007, Wall Street Journal.

What is Predatory Lending

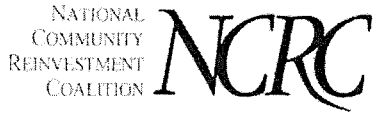
A subprime loan has an interest rate higher than prevailing and competitive rates in order to compensate for the added risk of lending to a borrower with impaired credit. NCRC defines a predatory loan as an unsuitable loan designed to exploit vulnerable and unsophisticated borrowers. Predatory loans are a subset of subprime and non-traditional loans. A predatory loan has one or more of the following features: 1) charges more in interest and fees than is required to cover the added risk of lending to borrowers with credit imperfections, 2) contains abusive terms and conditions that trap borrowers and lead to increased indebtedness, 3) does not take into account the borrower's ability to repay the loan, and 4) violates fair lending laws by targeting women, minorities and communities of color.

For a number of years, it was accurate to state that predatory lending generally occurs in the subprime mortgage market, where most borrowers use the collateral in their homes for debt consolidation or other consumer credit purposes. More recently, however, the surge of non-traditional lending confronts both prime and subprime borrowers with abusive situations. A significant amount of non-traditional lending starts off as a prime lending, but once the interest rate resets, this non-traditional lending often becomes subprime and predatory. In these cases, borrowers are faced with payment shocks and usurious monthly payments that they can no longer afford. Another significant segment of non-traditional mortgages starts off as subprime loans that stretch the margins of affordability but then become unaffordable as introductory rates expire.

Regulatory Guidance is Necessary but Not Sufficient

We are now confronted with a wider variety of predatory subprime and non-traditional loans. The federal regulatory agencies took too long to recognize the breadth and depth of highly risky subprime loans, but their implemented guidance on non-traditional mortgages and their proposed guidance on subprime mortgages are important steps towards protecting American consumers. Yet, as needed as this guidance is, it does not address the full dimensions of the predatory lending epidemic since the guidance applies to a subset of the industry. Moreover, it does not cover all abusive practices. Congress must pass a strong and comprehensive national anti-predatory bill in order to eliminate predatory lending.

The proposed regulatory guidance insures that borrowers of subprime adjustable rate mortgages (ARMs) will be able to afford their loans. The guidance requires lending institutions to assess borrower capacity to repay at the fully indexed rate, not the introductory "teaser" rate that could be several percentage points lower than the eventual Annual Percentage Rate (APR). In addition, the guidance requires lenders to engage in a robust analysis of borrower debt-to-income ratio, incorporating payments for taxes and insurance. A lack of escrows for insurance and taxes in subprime loans has confronted borrowers with unaffordable loans. Requiring that taxes and insurance be considered in



underwriting loans should assist in remedying borrower payment shock due to a lack of escrows. The guidance also discourages prepayment penalties extending beyond the time period of the teaser rates. Finally, the guidance emphasizes full and early disclosure to consumers regarding both the benefits and risks of ARM subprime lending.

The proposed guidance is necessary in that it appears to correct a significant deficiency of not accounting for borrower repayment ability in ARM subprime lending. A fundamental difficulty with ARM subprime lending is that the borrower is confronted with an unaffordable loan after the introductory rate expires.

But as needed as the proposed subprime guidance is, it does not cover most of the subprime market. In testimony last week before the Senate, the Senior Deputy Comptroller of the OCC estimates that hybrid ARM products are about 60% of the subprime market.[7] The coverage of the proposed guidance is even lower considering that the guidance would only apply to depository institutions regulated by the federal banking agencies. The Federal Reserve estimates that state-regulated lenders offered about 52% of subprime loans in 2005.[8] Assuming an even distribution of ARM lending among federal and state-regulated lenders, the proposed federal guidance would cover about 30 percent of subprime lending.

While the Conference of State Bank Supervisors successfully urged many states to adopt the non-traditional mortgage guidance covering non-amortizing option ARMs and interest only loans, a significant number of states have still not adopted the non-traditional mortgage guidance. This uneven application could also occur in the wake of federal agency implementation of the proposed subprime guidance.

Another fundamental reason why the proposed guidance is necessary but not sufficient is that the epidemic of predatory lending is caused by a plethora of actors involved in the beginning and end stages of lending. These actors range from brokers, appraisers, correspondents, depository lending institutions, loan servicers, securitizers, and Wall Street investors. The proposed guidance directly applies to depository institutions; while it asks depository institutions to monitor arrangements with third parties, the guidance cannot effectively act as a watchdog over the thousands of third party agents. Under the guidance, a bank should terminate its relationship with an abusive third party such as a wayward broker, but that broker would still be in business to pursue its abusive practices elsewhere. Moreover, the broker could be in compliance with a particular state law even if it was out of compliance with the federal standard.

Though urgently needed, the proposed guidance also does not address all of the abusive practices in the subprime market. The guidance does not have a clear prohibition on price discrimination or steering of borrowers creditworthy for prime loans or lower cost

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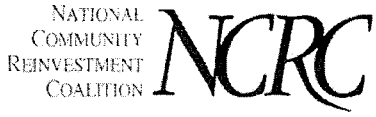
[7] Testimony of Emory W. Rushton, Senior Deputy Comptroller, before the Committee of Banking, Housing, and Urban Affairs of the United States Senate, March 22, 2007, p. 10.
[8] Greg Ip and Damian Paletta, Wall Street Journal, March 22, op cit.



subprime loans into high cost loans (below we discuss evidence of widespread steering). The guidance does not address abusive credit insurance products or the practice of mandatory arbitration, which have been abandoned by responsible financial institutions, but is still a significant problem in the subprime market. Appraisal fraud is pandemic, but not addressed in the guidance. Servicing abuses such as not recording timely mortgage payments and forced placed insurance are all too common, but not addressed in the guidance. Finally and importantly, a lack of due diligence and standards by the secondary market and Wall Street investors are large problems but are not addressed in the guidance. Only Congress has the power to comprehensively attack these abusive practices up and down the loan origination chain.

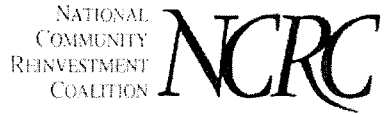
Another area of incompleteness in the proposed guidance is that it does not cover prime lending. Payment shock with hybrid ARM loans afflicts prime borrowers as well, experiencing sudden increases in monthly payments as initial rates expire. A comprehensive bill would require financial institutions to underwrite all loans at the fully-indexed rate.

Federal legislation is also needed to offer remediation for victims of predatory lending. Just recently, NCRC called upon the Administration and Congress to retool the FHA program so that it can refinance borrowers facing foreclosure and victimized by predatory lending. In addition, a foreclosure prevention fund is needed that would assist borrowers experiencing default through no fault of their own.

Does Rigorous Legislation and Regulation Choke Off Access to Credit?

Congress has been and will continue to be told that rigorous legislation and regulation will reduce lending and choke off the American Dream of Homeownership to millions of Americans. These assertions, however, fail to recognize that lending markets are broken and that legislation and regulation are needed to fix them. According to classical economic theory, markets work when there is a perfect flow of information and when actors internalize the "negative externalities" or harms of their actions. The difficulty with the lending markets is that neither of these conditions exist presently.

Buying a home is the most complex and important transaction for many Americans in terms of accumulating wealth. Yet, it is one of the least understood transactions for consumers. Even the best disclosure regimes imaginable will not eliminate the vast difference in knowledge between the borrower and lender. Unscrupulous lenders and brokers will find it too easy to manipulate borrowers into accepting abusive terms and conditions. Secondly, the loan officer or broker will not internalize the harm of his abusive actions because loans can be sold quickly into the secondary market. Secondary market investors often have no financial incentive to likewise internalize the harm of predatory lending since risk is precisely and surgically diversified by today's secondary markets. Governments, according to classical economic theory, intervene in the marketplace when the marketplace is broken. Such is the case today with abusive subprime lending.



The current evidence and academic research do not support the assertion that anti-predatory law fundamentally curtails banks' lending activities. In a paper entitled "Do Predatory Lending Laws Influence Mortgage Lending," Peter Nigro of the OCC and Keith Harvey of Boise State University conclude that North Carolina's anti-predatory law, the first in the country, did not affect the subprime market share of loans made to low- and moderate-income borrowers in North Carolina relative to five other Southeastern states. While the authors find a small decrease in the subprime market share to minorities, the change is "significant at the 10 percent level only." In other words, the change for minorities is barely statistically significant.[9]

In a more recent study, Professor Michael Stegman and his colleagues at the University of North Carolina concluded that the North Carolina anti-predatory law did not restrict overall access to credit, but did decrease loans with abusive features such as loans with prepayment penalties beyond three years.[10]

NCRC is aware that other studies come to opposite conclusions regarding the impact of anti-predatory laws. Professor Staten of Georgetown University asserts that anti-predatory law reduces the number of subprime loans to traditionally underserved borrowers.[11] These studies, however, suffer significant data and interpretative shortcomings. Staten's study relies on proprietary data supplied by a trade association of subprime lenders.

Regardless of whose studies are viewed with more credibility, it is beyond doubt that an impartial observer would conclude that the current level of academic research does not support assertions that state laws unequivocally choke off lending. For each study that asserts constriction of credit, another study discounts that possibility. Moreover, only one study, Stegman's, examines the types of loans affected by anti-predatory law. Until more studies are conducted with detailed data on loan terms and conditions, the most reasonable conclusion is that anti-predatory laws stop abusive lending beyond borrowers' repayment abilities instead of causing large scale reductions in loans.

The furious debate over the role of subprime lending obscures the critical role of Community Reinvestment Act (CRA)-related prime lending and FHA lending in serving minorities and working class Americans. If abusive subprime lending is reduced, NCRC believes that responsible lending would take its place in serving minorities and working

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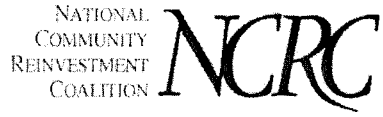
[9] "Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending Law," September 2002, Keith D. Harvey, Boise State University, and Peter J. Nigro, OCC, see pg. 14 and 25.

[10] "The Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Assessment," Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis, June 25, 2003, the Center for Community Capitalism, University of North Carolina at Chapel Hill.

[11] "Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law," October 2002, Gregory Elliehausen and Michael Staten, McDonough School of Business, Georgetown University.



class Americans. In the mid-1990's, the Clinton Administration ordered regulators to bolster the rigor of CRA exams. As a result, several studies, including those by the Treasury Department and Harvard University, documented a significant surge in prime lending by banks to minorities and low- and moderate-income people.[12] Furthermore, FHA had a much more prominent role in the lending marketplace than it has today.

Unfortunately, CRA-related prime lending has leveled off and FHA market share has plummeted at the same time that abusive subprime lending has surged. The stagnation of CRA prime lending and FHA lending does not mean that these products are inferior or cannot meet the needs in today's marketplace. Instead, abusive lending has a tendency to crowd out responsible prime, subprime, and FHA lending. Unscrupulous brokers and lenders will peddle abusive loans because they reap usurious fees from predatory loans. To these brokers and lenders, predatory loans appear to be more profitable than responsible lending. Too many abusive lenders have been choosing the quick buck extracted from predatory loans rather than the longer term profits and benefits of responsible lending. But if Congress acts to correct the broken marketplace, responsible lending will rise and overall access to credit will not be choked off for minorities and working Americans. The abusive lenders will be out of business, and responsible lending will once again be able to prosper.

Safety and Soundness

For NCRC, protecting American families and communities are paramount. Yet, predatory lending also poses serious risks for financial institutions. In your invitation letter asking NCRC to testify, you ask if the safety and soundness of federally regulated institutions is at issue in the current subprime market. NCRC believes that serious safety and soundness risks are present. A number of years ago, the FDIC reported that although subprime lenders constituted about 1 percent of all insured financial institutions, they accounted for 20 percent of depository institutions that have safety and soundness problems.[13] If this was the case several years ago, it is likely to be worse now. Although regulatory agencies were aware of serious safety and soundness risks, they acted too little, too late as they themselves admitted last week at the Senate hearing.[14]

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[12] The Joint Center for Housing Studies at Harvard University, *The 25th Anniversary of the Community Reinvestment Act: Access to Capitol in an Evolving Financial Services System*, March 2002; Robert Litan, Nicolas Retsinas, Eric Belsky and Susan White Haag, *The Community Reinvestment Act After Financial Modernization: A Baseline Report*, produced for the United States Department of the Treasury, April 2000; *The Performance and Profitability of CRA-Related Lending*, Report by the Board of Governors of the Federal Reserve System, July 17, 2000; Raphael Bostic and Breck Robinson, *Do CRA Agreements Influence Lending Patterns?* July 2002, available via bostic@usc.edu.

[13] Department of Treasury, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Proposed Agency Information Collection Activities (Collecting subprime lending information on call reports), Federal Register, May 31, 2000, pages 34801-34819.

[14] Stacy Kaper, "Dodd Takes Aim at Fed; Greenspan Fires Back," *American Banker*, March 23, 3007.

The safety and soundness risks are demonstrated in the commendable action taken by the FDIC in the Fremont Investment and Loan case. Fremont Investment and Loan was one of the country's largest subprime lenders until the FDIC ordered the bank to cease and desist its subprime operations in early March of this year. The FDIC found that Fremont's subprime lending was not safe and sound since ARM loans were underwritten at the initial rate, the underwriting included little documentation of borrower income, prepayment penalties far exceeded the end of the initial teaser rate time periods, and flipping was an increasing likelihood as borrowers could not keep up with loan payments.[15]

The case of Fremont Investment and Loan also illustrates the intersection between consumer protection and safety and soundness. The termination of Fremont's subprime business will likely increase market opportunities for responsible lenders. In 2005, Fremont Investment and Loan issued 58,448 subprime first lien home purchase loans according to the FFIEC web page. At the same time, WMC Mortgage Corp. made 44,513 first lien home purchase loans. WMC announced at last week's Senate hearing that it would adhere to the new regulatory guidance while Fremont Investment and Loan was violating the basic tenets of the regulatory guidance. If regulators stepped up their enforcement, responsible lenders would increase their lending as the abusive lenders such as Fremont Investment and Loan would be driven out of business. Overall access to credit would not be reduced; instead the quality of credit offered in the marketplace would improve.

Fremont Investment and Loan was a rare and significant regulatory action during the last several years. The disturbing question remains about how much more dangerous lending is occurring right under the noses of the regulatory agencies. Will this lending be stopped or will it continue until it bankrupts communities and lending institutions?

NCRC's Consumer Rescue Fund Reveals Breadth and Depth of Predatory Lending

While responsible subprime and non-traditional lending fill legitimate credit needs, all too often, NCRC has seen firsthand the devastation wrought by predatory subprime and non-traditional lending. This devastation is made visible to us through our national Consumer Rescue Fund (CRF) program. NCRC's Consumer Rescue Fund illustrates how abusive tactics have impacted entire communities and hardworking people.

Through the national anti-predatory lending Consumer Rescue Fund (CRF), NCRC works with victims of predatory lenders so their mortgage payment becomes more affordable and foreclosure can be avoided. The CRF identifies consumers who are in predatory mortgages and fixes the mortgages through mediation with lenders or arranging

[15] For the FDIC cease and desist order, see http://www.fdic.gov/bank/individual/enforcement/2007-03-00.pdf

for refinance loans.[16] Consumers contact NCRC member organizations participating in the CRF program. In a number of instances, the NCRC members in the CRF program are counseling agencies assisting consumers experiencing delinquency and default on their loans. NCRC and over 30 participating member organizations in Arizona, Ohio and New York launched the CRF initiative in October 2001 to help victims of predatory lenders. Today, the CRF has a nationwide reach, serving consumers in 17 states.

Targeting Minority and Working Class Americans

A NCRC review of CRF cases indicate that abusive lenders are targeting minority and low- and moderate-income borrowers and communities with high cost and exotic mortgages.[17] The CRF cases also reveal that predatory loans do not usually contain just one or two abusive terms and conditions. More often, a toxic loan in the CRF program contains several abusive features including ARM loans with lax underwriting considering only the initial rates, exaggerated borrower incomes, payments that borrowers cannot afford, exorbitant fees and yield spread premiums, piggyback lending beyond borrower repayment abilities, and abusive servicing. Risk layering of a number of exotic features – interest-only, option ARMs, piggyback Home Equity Lines of Credit (HELOCs), high loan-to-values, stated income – is a recipe for financial disaster for borrowers with limited incomes and/or imperfect credit.

CRF staff report that exotic mortgage lending has increased in recent years as housing costs have increased around the country. Unscrupulous lenders are trying to concoct methods to qualify borrowers for homes they cannot afford or can barely afford. Stated-income loans forego the usual documentation of a borrower's income level through pay stubs and tax returns. Using stated-income loans, abusive lenders/brokers can readily inflate incomes to quality borrowers for unaffordable loans. Abusive lenders are also qualifying borrowers for option Adjustable Rate Mortgage (ARM) loans using initial rates as low as 1%.

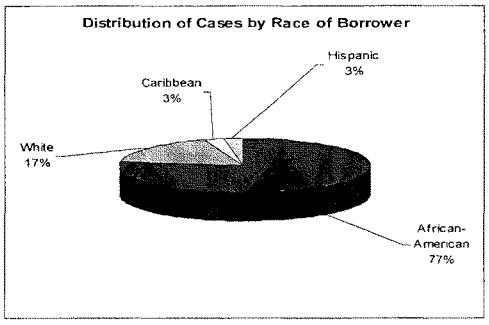
The graphs and charts below reveal that a disproportionate number of CRF customers are people of color and have modest incomes. About 77% of the borrowers in the CRF sample were African-American and 55.4% of the borrowers resided in substantially minority census tracts (more than half the population in the census tract was minority according to the 2000 census). Almost half (47%) resided in low- and moderate-income neighborhoods and 83.6% of the borrowers had incomes below $45,000. The findings that CRF customers were mostly minority and low- and moderate-income is consistent

[16] HSBC North America provides refinance loans for the CRF program and supports CRF counseling. Other sponsors of the CRF program include Select Portfolio Servicing, Inc, the Ford Foundation, Freddie Mac, The Fannie Mae Foundation, Fannie Mae, The JP Morgan Chase Foundation, and The Heron Foundation.

[17] For more detail about the CRF fund, see the report by NCRC and the Woodstock Institute, *Asset Preservation: Trends and Interventions in Asset Stripping Services and Products*, September 2006, at http://www.ncrc.org/policy/analysis/policy/2006/2006-09_LifetimeOfAssets_NCRC-WoodstockPaper.pdf

with NCRC's research below documenting that a disproportionate amount of high cost lending is directed towards minority and working class communities. Traditionally underserved communities suffer from less product choice and consequently are more susceptible to abusive high cost and exotic mortgage lending.

CRF Cases by Race of Borrower



CRF Cases

Distribution of Cases by Minority Level of Neighborhood

Minority Level of Neighborhood	Number	Percent
Not substantially minority	38	33.93%
Substantially minority	62	55.36%
N/A	12	10.71%
Total	112	100.00%

Distribution of Cases by Income Level of Neighborhood

Income Level of Neighborhood	Number	Percent
Low	7	6.25%
Moderate	46	41.07%
Middle	32	28.57%
Upper	15	13.39%
N/A	12	10.71%
Total	112	100.00%

Note: Income of borrower not available for as many cases

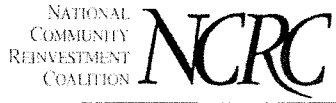
Distribution of Cases by Income of Borrower

Income of Borrower	Number	Percent
less than $15,000	6	9.84%
$15,001-25,000	14	22.95%
$25,001-35,000	16	26.23%
$35,001-45,000	15	24.59%
$45,001-55,000	5	8.20%
$55,001-65,000	2	3.28%
$65,001-75,000	1	1.64%
$75,001-85,000	2	3.28%
Total	61	100.00%

Multiple Abuses in Exotic and High-Cost Loans in CRF Sample

Minority and working class borrowers confront an array of predatory abuses described in the graph below. While some abuses have declined in recent years such as prepaid credit insurance, most loans in the CRF program have multiple abuses confronting borrowers with loans that they can no longer afford and loan terms they can no longer negotiate. If the loans had just one or two abuses, it would be easier for the borrower to either afford the loan or succeed in modifying the loan with the lender. The multiple nature of the abuses, however, suggest that the predatory lender or broker maximized profit by designing a loan that was destined to fail or to be flipped. The multiple nature of the abuses suggest that the predator was not interested in satisfying a borrower credit need but instead quickly extracting as much equity as possible.

Abuses	Description
asset-based lending	Lenders evaluate a loan application by looking only at the quality of the security or equity, and not at the ability of the borrower to repay the loan
forced placed insurance	Servicer assigns hazard insurance to borrower, coverage is usually much more expensive
HOEPA loan	A loan with a very high interest rate and/or fees that is covered by federal consumer protections. Predators violate the legal protections of HOEPA loans.
Mandatory arbitration	Stipulation that a borrower cannot sue a lender in a court of law, but must use an arbiter
prepaid credit insurance	Insurance financed into the loan that would cover mortgage payments in a case of disability, unemployment, death. Much more expensive than paying monthly outside of loan
abuse of right to cancel	Abusive practices that make it hard for a consumer to cancel a mortgage (ie. abusing right of rescission)
abusive collection practices	Aggressive tactics of collecting late payments
default interest rate	Increasing interest rate in case of delinquency
excessive prepayment penalty	Excessive fee for paying off a mortgage before its maturity
insincere co-signers	Adding insincere co-signers to the application in order to inflate the income of the borrowers. Abusive lenders will add children and other insincere co-signers who cannot contribute to loan payments.
loans made in excess of 100% LTV	When the loan amount exceeds the fair market value of the home
negative amortization	Loan product that requires a monthly payment that does not fully amortize a mortgage loan, thereby increasing the loan's principal balance
flipping	Persuading a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced
fraud	Example: Forging signatures on loan documents
lack of TNB	Lack of tangible net benefits that justify the origination of a new, higher-balance and high-cost loan
targeting/discrimination	Cases when lenders specifically market predatory loans to customers based on race, ethnicity, or age
predatory appraisal	Overestimating the market value of the house
balloon payment	A mortgage that has level monthly payments over a stated term but which provides for a large lump-sum payment to be due at the end of an previously specified term
equity stripping	A case when a homeowner's equity is reduced due to repeatedly refinancing, high fees, and other abuses
home improvement scam	Home improvement costs financed into the mortgage usually paid by a lender to a home improvement contractor directly.



misrepresentation	Misrepresentation of loan terms to a borrower
falsified application	Falsifying loan applications (particularly income level or adding insincere co-signers, etc.)
Stated income	Not requiring full documentation of income from tax forms and paystubs. Reduced documentation or stated income loans increase the chances of fraud.
yield spread premium	Fee paid by lenders to brokers for loans carrying interest rates above a par rate
abusive servicing practices	Servicers not recording payments, force placing insurance, applying high late fees, etc.
unfair terms	High interest rates and loan terms not justifiable by risk (consumer's credit score)
fee packing	Charging undisclosed, improper, and high fees

The sum total of the abuses equals loans that are considerably beyond borrower repayment ability. A sample of 69 CRF cases included calculations of the monthly housing payment-to-income ratio (front-end ratio) and the monthly total debt-to-income ratio (back-end ratio). The front-end and back-end ratios of the predatory loans in the CRF sample were considerably higher than common limits in standard underwriting guidelines. The average front-end ratio was about 41% and the median was 35.4%. The average back-end ratio was 50.3% and the median was about 50% as shown in the graph below. Standard front-end and back-end ratios for prime loans are 28% and 36%, respectively. The considerably higher ratios of the predatory loans in the CRF sample suggest that the loans were beyond the consumers' abilities to repay, leading to financial distress and/or bankruptcy and foreclosure.

CRF Cases **Unaffordable Loans**

Debt-to-income Ratios

	Front-end Ratio	Back-end Ratio
Average	40.77%	50.28%
Median	35.43%	49.78%

Compounding the high front- and back-end ratios was the fact that most of the loans in the CRF sample did not have escrows covering property tax payments and hazard insurance. Two thirds of the borrowers in the CRF sample did not have escrow accounts. On top of housing payments and debt levels that were unsustainable, a number of the CRF borrowers experienced payment shock when they discovered that they had thousands of additional dollars in taxes and hazard insurance payments that were not covered by the loans.

The case studies immediately below illustrate the multiple abuses on the CRF loans, and how predatory lenders and brokers take advantage of hard-working Americans who are striving mightily to achieve or preserve their American Dream of homeownership. The case studies reveal that aggressive "push-marketing" by predators result in consumers receiving loans that are unaffordable and unsuitable, when tragically an appropriate product would have worked fine.

CRF Case Studies

Case Study 1 – Miami, Florida: Steering into Over-Priced and Unsuitable Loan, Fasifying income, Stated-Income and Exotic Mortgage Loan

In January of 2006, Ms. Jean-Simon of Miami, Florida was seeking to become a first-time homeowner. She had a good credit score of 747, and she had a modest income of $3,200 per month. She was a hard-worker, holding a full-time job at the University of Florida and two part-time vendor jobs at local sports stadiums. Incredulously, her mortgage broker pressured her to not use a first-time buyer program through Miami Dade County or other government programs. She was told these programs "take too long" and "require too much paperwork"

The broker falsified Ms. Jean-Simon's income to $5,000 per month. In other words, her income was exaggerated by 56%. The total loan amount was for $170,000 and was financed at 100%. Her first loan was an option ARM (four payment options, with the lowest being "negative amortization"). The maximum rate on the option ARM was 9.95%. To make matters worse, she had a piggyback loan, which was a line of credit with a maximum rate of 11.75%. Because her income was falsified, she could only afford the minimum payment. Therefore, she was increasing her principal balance through negative amortization.

Case Study 2 – Trevose, Pennsylvania: High Broker Fees, Steering, 2/28 ARM, Abusive Servicing

Sixty-nine year old Gladys Christian refinanced her home twice in her 31 years of homeownership. She used her cash equity from both transactions to pay for a car and to make home improvements. The second refinance, however, presented Ms. Christian with more problems than benefits. Ms. Christian's loan settled at the cost of over $10,000 in broker and third party fees, and also generated high monthly payments. Despite Ms. Christian's good credit history, she was qualified for an 8.9% two-year fixed, twenty-eight year adjustable rate mortgage that could climb as high as 15.90%.

Even though Ms. Christian was retired, she used her 33 years of experience in nursing to continue provide nursing services for the elderly. She used this income along with her pension and Social Security payments to keep up with her payments in order to avoid serious delinquencies on her loan. She only called Legal Aid of Southeast Pennsylvania

for assistance when she became ill, missed a payment, and struggled to manage this delinquency with her lender's servicer. Rather than work out a forbearance plan, her lender and servicer initiated foreclosure proceedings.

Case Study 3 – Belgium, Wisconsin: Falsified Income, Hybrid ARM, Piggyback Loan, Risk Layering

In September 2006, Duane and April West, a vibrant young African-American couple, contacted NCRC because they could no longer afford their mortgage payments. Although the West's both worked full time jobs (Duane works for Enterprise Rent-a-Car, and April works as a loan closer for a title company), they knew that they were one or two months away from missing their mortgage payments and sinking into foreclosure.

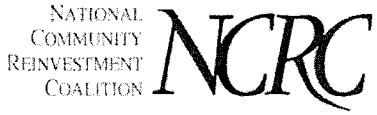
Upon reviewing the West's loan documents, CRF staff noticed the loan had layers of financial risk. First, the West's loan relied on a combined household income that was falsified by 66%. Second, the Wests hoped their refinance loan would pay off their car note, but the loan only increased their indebtedness, left them with an unpaid car note, and not enough funds to pay off any other debt. Third, the two refinance loans were usurious and predatory. The first loan was a two-year fixed, twenty-eight year adjustable rate mortgage combined with a five-year interest only period. The second, piggyback loan was a balloon mortgage with a 13% rate. While severe payment shock was built into these refinance loans, the couple had enough experience to realize that the income falsification was presenting them with unaffordable loans before the reset.

Case Study 4 – Oakland, California: Flipping, high fees, predatory prepayment, stated income loan, ARMs, mortgage payment out of proportion with income.

Ms. Smith is an African-American who bought a home in Oakland, California in December 1999. At the time of the incident, her income was $47,328 annually, or $3,944 monthly. She has undergone a series of unnecessary refinances, each of which has added a multitude of duplicative fees and has inflated the amount that she owes.

In December 1999, Ms. Smith purchased her home for $108,000. Approximately nine months later, she underwent her first refinance, which she thought would lower her rate and allow her to cash out a modest amount of money for roof repairs. Instead, this new mortgage for $140,250 stripped equity by paying off a prepayment penalty without her knowledge. Further, the Good Faith Estimate for this transaction also shows that Ms. Smith was to be charged lender and broker fees of 5.76 points (5.76 percent of the loan, or $8,076), an amount much greater than typical prime fees of 1 percent of the loan amount. Also, Fannie Mae and Freddie Mac have pledged not to purchase loans with fees exceeding 5 percent of the loan amount, and 5 percent is often the threshold in anti-predatory lending laws, triggering additional protections.

In August 2001, less than a year after her first refinance, Ms. Smith refinanced a second time. The new loan for $187,500 was adjustable and carried a three-year prepayment



penalty. In October of 2003, Ms. Smith refinanced a *third* time, this time a 30-year fixed loan for $240,000. She refinanced for a *fourth* time in July 2004. On this loan, her income was greatly inflated at $6,000 monthly, when it in fact was only $3,944. Consequently, the monthly payment on this fourth and final refinance was $1,887, which was an overwhelming 47.87 percent of her income.

CRF Encounters Entire Devastated Communities Due to Predatory Loans and Appraisals

In the communities of Staten Island and Long Island, New York, the Consumer Rescue Fund is assisting over 100 New York City police officers and fire fighters who purchased homes from an unscrupulous housing developer and mortgage broker. The broker manipulated the origination system by quickly dumping the fraudulent loans onto the secondary market. For these heroic public employees, the American dream of owning a home has now become their nightmare.

Lastly, but importantly, NCRC's CRF program is intervening in a significant number of cases where borrowers have been victimized by appraisal fraud. A sample of CRF loans revealed that about one fifth of the homes were overvalued by more than 50% of their true value, and two thirds of the homes were overvalued by 15-50% more than their true value.[18] Inflating appraisals leave borrowers with unaffordable loans that they are unable to refinance because the loan amounts are higher than the true value of their homes, especially as the housing market cools in the next few years. The results are too often theft of homeowner wealth, equity stripping, and/or foreclosure.

Fair Lending Testing Provide Vivid Examples of Disparate Treatment and Pricing

NCRC's mystery tests under a Department of Housing and Urban Development Fair Housing Initiative Program (FHIP) Private Enforcement Initiative Grant reveals how borrowers can end up in unsuitable, usurious, and over-priced loans. The mystery tests clearly demonstrated how minorities with creditworthiness similar to whites where steered towards higher prieed fixed and ARM loans. Under the FHIP grant, NCRC conducted subprime fair lending testing of large lenders in six major metropolitan areas throughout the United States. The results provide detailed and vivid examples of disparate treatment and pricing in subprime lending based on race and gender.

NCRC conducted forty-eight tests of 12 subprime lenders with retail outlets serving the metropolitan areas of Atlanta, Baltimore, Chicago, the District of Columbia, Los Angeles, and New York City. We conducted this national testing project with the assistance and cooperation of local NCRC members, community organizations, civil rights activists, and consumer protection organizations.

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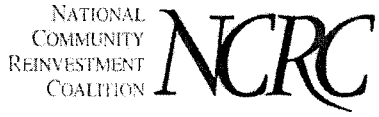
[18] See NCRC's report, *Predatory Appraisals: Stealing the American Dream*, June 2005, http://www.ncrc.org/responsible-appraisal/pdfs/AppraisalReport.pdf



The testing uncovered a 45% rate of disparate treatment based on race. In particular, the testing uncovered several practices that have a disparate impact upon African-American consumers, and predominately African-American communities. Additionally, the testing uncovered a number of instances of sex discrimination. Finally, the testing uncovered the need for changes in the policies and practices of the lenders in order to make loans more accessible to all consumers on an equal basis. Moreover, in a number of the tests, loan staff failed to follow publicly stated lender best practices, such as referral up to a prime loan for qualified mortgage applicants.

NCRC carefully developed testing methodology. NCRC employed matched paired site visit tests in 40 of 48 tests. The second test type was matched paired telephone tests. In all of the testing (which was pre-application testing), the tester contacted the lending institution and indicated that they (the tester and spouse) were interested in obtaining a home equity loan. All testers were given a profile indicating that they were qualified for a prime loan. All tester profiles indicated that the testers were married and were long time homeowners with substantial equity in their homes. All testers had a low loan to value ratio (below 80% after the requested home equity loan), a good debt to income ratio (below the 36% often used for conventional loans), and the tester represented that they had good credit. While tester profiles were substantially similar, African-American testers were given profiles which made them slightly more qualified, in that they had more income, better ratios, higher credit score, and longer time in the home and on the job.

The testing results indicated that 45% of the time there was a difference in treatment by the lender favoring the White tester. The types of differences in treatment detected were:

* Differences in interest rates quoted.

* Differences in information given regarding qualification standards, fees, required ratios, interest rates, loan programs, and terms of loans.

* Differences in levels of courtesy and service.

* Differences in materials and literature given.

* Differences in number and types of questions asked of the testers.

* The White testers were more often "referred up" to the lender's prime lending division.

* The White testers were more often quoted interest rates.

* The White testers were quoted lower interest rates, or range of rates.

* The White testers were given more detailed information.

* The White testers were often assumed to be qualified, and given recommendations based upon assumed qualifications.

* The loan officers spent more time with the White testers.

* The White testers received more follow-up.

* The Black testers were often asked about the condition of their house; the White testers were not.

* The Black testers were more often asked what they wanted to do with the money.

The following two vignettes provide detail of startling differences in treatment and price quotes.

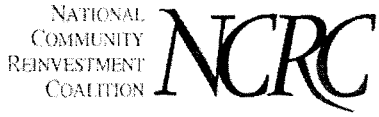
In Baltimore, testers met with the same loan officer at a branch of the subprime affiliate of a major national lender. The Loan Officer assumed the White tester was overqualified and without asking any financial questions, told her she could get better rates at the prime branch of the parent company. The Loan Officer also gave the White tester general rate ranges. However, the Loan Officer would not give the Black Tester any rate information, citing the need for a credit check. The Loan Officer crumpled and discarded the Black tester's application when she would not reveal her Social Security number.

In another test in Baltimore at a suburban branch of a major subprime lender, the White tester was told of a 5.75%, 30 year fixed interest rate, while the Black tester was told the 30 year rate was 8.85%. The White tester was told the 2 year adjustable rate was 4.99% and the Black tester was told the rate for that product was 7.6%. The Black tester was told that since her husband made more money (just slightly more), the lender would rely on the husband's income and credit. The White female tester was not asked about income, nor told about this policy.

Discrimination by Mortgage Brokers in Wholesale Channels

Unfortunately, NCRC's mystery shopping reveals discrimination and abusive practices committed by brokers as well as by mortgage companies and banks. From 2004 to 2006, NCRC conducted mystery shopping of mortgage brokers, both large and small. Posing as loan seekers, both White testers (the control group or Comparison group) and Black or Hispanic testers (the protected group) met with and called local brokers to inquire about their loan options.

Both groups of testers presented themselves as having plenty of equity, stable income and good credit. The protected-class testers were actually given more attractive profiles in terms of their amount of equity, credit standing and employment tenure, and should have logically received better treatment.



However, these Black and Hispanic testers only were favored in a very small minority of the cases. White testers were routinely shown higher levels of service, of encouragement and given more information about loan products. In the most egregious cases, members of the control group were given better pricing, and the tested companies represented their policies differently to the two testers.

In 2006, the lending marketplace finds itself in a unique situation.

Over the last decade, brokers' market share has exploded to about 70% of all originations. Mortgage rates have dropped, and now have been creeping back up as rumblings of a real estate bubble are on the horizon. For an institution lending primarily through a wholesale channel, brokers act like subcontractors. For such a wholesaler, using brokers to sell their products can be cheaper and more efficient. The costs, for example, of maintaining brick-and-mortar branch office infrastructure or paying health insurance are passed on. With the refinance boom ebbing, traditional institutions that use brokers are spared the unpleasantness of having to lay off their own workers. Clearly, brokers can provide a valuable service to mortgage lenders, lowering costs and making the industry more flexible and efficient. Yet, these advantages are compromised when brokers engage in discriminatory and abusive behavior.

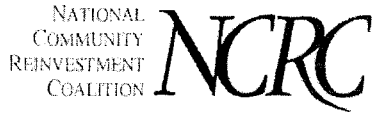
NCRC's broker testing yielded 106 total complete, matched-pair tests. Individuals located in the metropolitan areas of Atlanta, Baltimore, Chicago, the District of Columbia, Houston, Los Angeles and Saint Louis tested brokers that were local, established businesses. In conducting the broker testing, NCRC found several companies with particularly egregious initial results. In these cases, testers were again dispatched for follow up testing to confirm and further investigate the practices of these companies. Of the 106 total tests, 84 separate companies were tested, the difference being as a result of 22 follow up tests.

A portion of the follow up tests were directed at Allied Home Mortgage Capital Corporation, against whom NCRC has already filed a fair housing complaint. Additional complaints may also be filed, pending further investigation.

Our results documented the following disturbing patterns:

1. African Americans and Latino's were discouraged 25% of the time concerning their efforts to meet with a broker, while Comparison testers were discouraged only 12% of the time in their efforts to obtain credit.

2. Brokers spent more time with white shoppers then African Americans and Latinos, spending on average 39 minutes with white testers and only 27 minutes with African American and Latino testers.



3. White mortgage seekers received greater encouragement over sixty percent of the time, while African Americans and Latinos were questioned about their credit over 32% of the time. White shoppers were only questioned about credit 13% of the time.

4. White mortgage seekers had specific products discussed with them 91% of the time, while African Americans and Latinos had specific products discussed with them 76% of the time. Further, White testers received two rate quotes for every one quoted to African American and Latino testers.

5. NCRC documented pricing discrimination in 25% of the fair lending tests, and noted that fees were discussed 62% of the time with white testers but only 35% of the time with "protected testers."

6. Fixed rate loans were discussed 77% of the time with white testers but only 50% of the time with African American and Latino testers.

These results are very troubling and document the fact, controlling for credit and individual applicant qualification factors, African Americans are being discriminated against in the marketplace and being forced to pay a "race tax" due to unequal access to credit.

Pricing Disparities Cannot Be Explained Away

So far, the testimony has presented compelling testimony from two NCRC programs (CRF and civil rights enforcement via mystery shopping) revealing predatory and discriminatory practices in high cost and non-traditional mortgage lending. We believe that the experiences under the two NCRC programs are not random, but widespread. Data analysis of a national database, the Home Mortgage Disclosure Act (HMDA) indicates that predatory lending is a national epidemic, and not confined to a few localities or a few lenders.

Price discrimination is not often discussed in the context of predatory lending, but we believe that it is a central element of predatory lending. When a borrower is steered towards a loan with an Annual Percentage Rate (APR) two or three percentage points higher than the loan for which she qualifies, the borrower will pay tens of thousands or hundreds of thousand dollars more in mortgage costs due to the discrimination. This represents a substantial loss of wealth, which could have been used to send a child to college or start a small business.

In 2003, NCRC released a path-breaking study, entitled the *Broken Credit System*, documenting price discrimination on a national level.[19] We found that after controlling for creditworthiness and housing characteristics, the amount of subprime refinance loans increased as the number of minorities and elderly increased in neighborhoods in ten large

[19] See NCRC's *Broken Credit System* at http://www.ncrc.org/policy/cra/documents/ncrcdiscrimstudy.pdf

metropolitan areas. In addition to the NCRC report, two studies conducted by Federal Reserve economists also found that subprime lending increases in minority neighborhoods after controlling for creditworthiness and housing market conditions.[20] The Center for Responsible Lending also recently used the 2004 HMDA data with pricing information to reach the same troubling conclusions that racial disparities remain after controlling for creditworthiness.[21]

NCRC has conducted two more recent studies documenting the persistence and stubbornness of pricing disparities. In a study released in March of 2005, we found that pricing disparities to minorities, women, and low- and moderate-income borrowers are pervasive throughout the great majority of metropolitan areas in the country.[22] Using 2003 Home Mortgage Disclosure Act (HMDA) data, we observed that subprime lenders offered a greater percentage of their loans than prime lenders to women, African-Americans, and Hispanics in 100%, 98.5% and 89.1% of the nation's metropolitan areas, respectively.

Strikingly, the disparities were worst in a number of medium-sized metropolitan areas. In Macon, Georgia, for instance, subprime lenders made 59.3 percent of their home loans to African-Americans while prime lenders issued only 13.7 percent of their loans during 2003 to these borrowers. In Corpus Christi, TX, subprime lenders offered 53.1 percent of their home loans to Hispanic borrowers while prime lenders made just 28.3 percent of their loans to Hispanics in a metropolitan area whose population is 55 percent Hispanic. The finding that many medium sized metropolitan areas in states with relatively weak anti-predatory laws experienced large pricing disparities indicates a need for national legislation.

We also discovered that as the level of racial segregation was higher in a metropolitan area, the portion of subprime loans in minority neighborhoods was higher, controlling for the affordability of homeowner units. Again, this finding reveals that lender decisions are not driven only by legitimate differences in creditworthiness. Instead, the finding suggests intensified targeting of minority neighborhoods as segregation increases since segregation makes it easier for lenders to identify and target minority neighborhoods.

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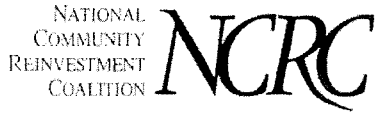
[20] Paul S. Calem, Kevin Gillen, and Susan Wachter, *The Neighborhood Distribution of Subprime Mortgage Lending*, October 30, 2002. See also Paul S. Calem, Jonathan E. Hershaff, and Susan M. Wachter, *Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities*, in Fannie Mae Foundation's Housing Policy Debate, Volume 15, Issue 3, 2004 pp. 603-622.

[21] Center for Responsible Lending, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, see http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=29371010

[22] NCRC, *Fair Lending Disparities by Race, Income, and Gender in All Metropolitan Areas in America*, March 2005, available via http://www.ncrc.org. Prior to the 2004 data, researchers have used a list developed by the Department of Housing and Urban Development of subprime and manufactured housing specialists to document patterns of subprime and prime lending.



Another study, NCRC's *Homeownership and Wealth Impeded* report uses the 2004 HMDA data to examine in detail pricing disparities by race and gender when controlling for income levels.[23] The report uncovers troubling evidence that racial disparities increase when income levels increase. For example, subprime loans made up a high 41.9 percent of all refinance loans to low- and moderate-income (LMI) African-Americans. In contrast, subprime loans were 19.2 percent of refinance loans to LMI whites in 2004. LMI African-Americans were 2.2 times more likely than LMI whites to receive subprime loans. Even for middle- and upper-income (MUI) African-Americans, subprime loans made up a large percentage (30.2 percent) of all refinance loans. Moreover, the subprime share of loans to MUI African-Americans was 2.7 times larger than the subprime share of loans to MUI whites. The same pattern of disparities increasing with income occurred when the report examined lending to females compared to males or in immigrant neighborhoods compared to predominantly white neighborhoods.

NCRC's report, the *2005 Fair Lending Disparities: Stubborn and Persistent II* was one of the first reports conducted with the new 2005 HMDA data and showed stubbornly persistent disparities by race and gender.[24] The study uses data collected from 17 large lenders. The study finds a large surge in high-cost lending from about 12.2 percent of all loans in 2004 to 28.2 percent of all loans in 2005. Of all the conventional loans made to African-Americans, 54.5 percent were high-cost. In contrast, of all the conventional loans issued to whites, 23.3 percent were high-cost as shown in the graphs below. Hispanics and Native Americans also received a disproportionate amount of high-cost loans. About 40.7 percent and 35 percent of the conventional loans made to Hispanics and Native Americans, respectively, were high-cost loans. Of all the conventional loans issued to females, 34.4 percent were high-cost. In contrast, just 26.2 percent of the loans for males were high-cost during 2005.

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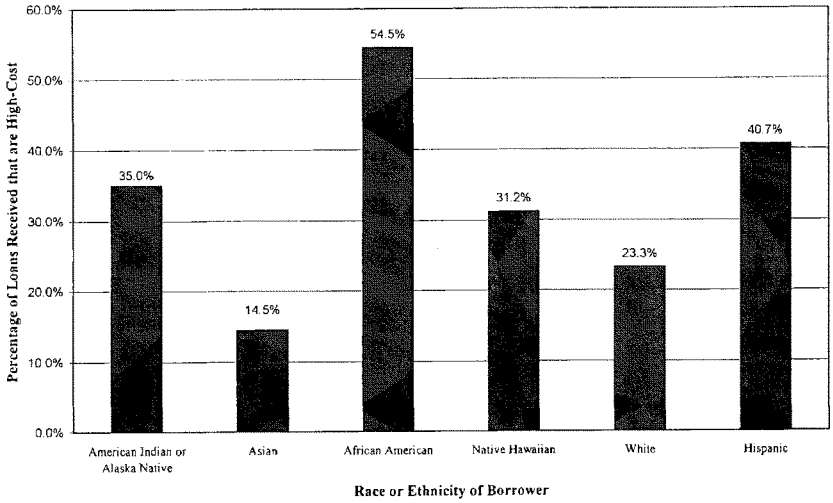
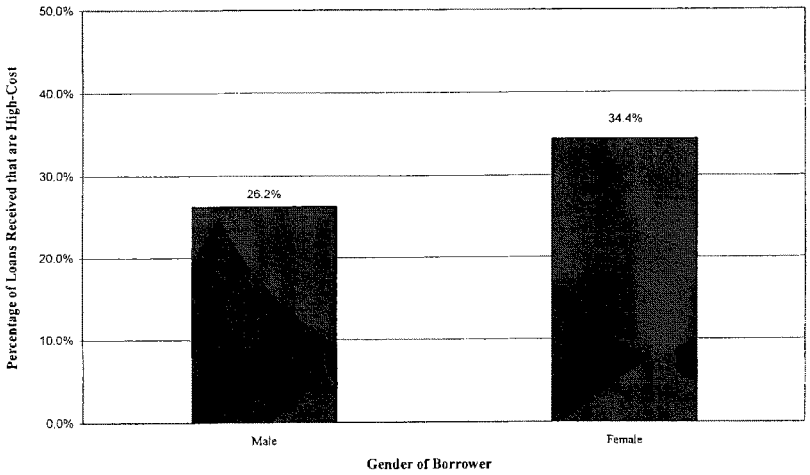
[23] To access NCRC's report, *Homeownership and Wealth Building Impeded*, please go to http://www.ncrc.org/policy/analysis/policy/2006/2006-04-20_NCRC-OA-PRRACReport.pdf
[24] To access NCRC's Fair Lending Disparities: Stubborn and Persistent II, plese go to http://www.ncrc.org/policy/analysis/policy/2006/2006-05-23_2005HMDAreport.pdf

NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

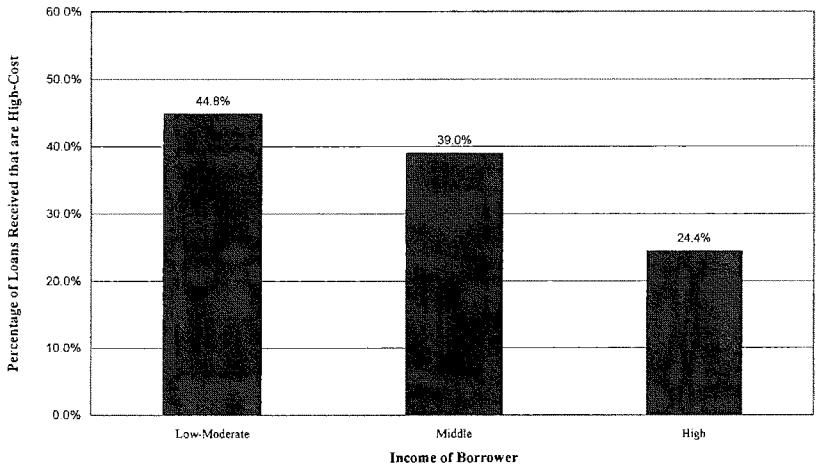
Minorities Receive Disproportionate Amount of High-Cost Loans



Women Receive Disproportionate Amount of High-Cost Loans



High-Cost Lending Prevalent Among Low-Moderate & Middle-Income Borrowers



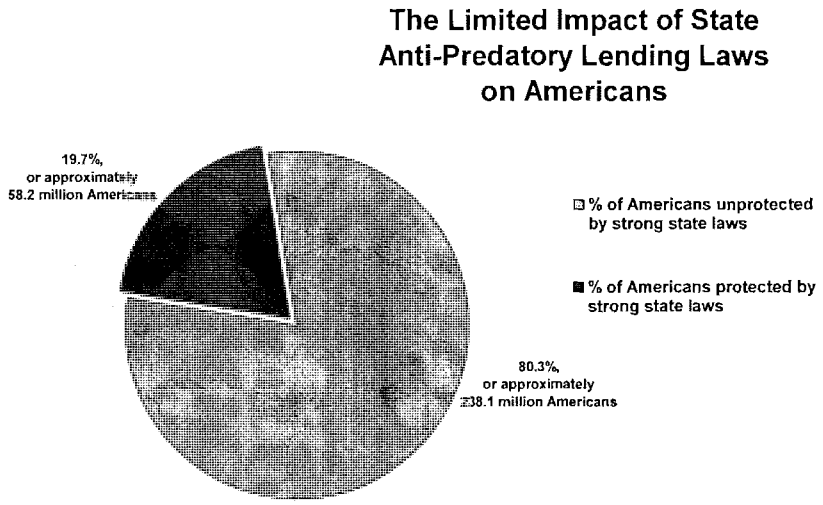
Even middle-income borrowers are now receiving a substantial portion of high-cost loans; 40 percent of the loans made to middle-income borrowers were high-cost loans in NCRC's 2005 sample. In addition, disparities by race and gender remain stubborn and persistent. The facts that lending disparities remain significant by race and gender and impact a significant segment of middle-income Americans suggest that fairness in the lending marketplace is now a pressing issue for a broad segment of Americans. NCRC's studies over the years reveal that unsavory lender behavior is responsible for a significant amount of the persistent pricing disparities. Lawmakers must act to protect homeowner equity.

Need for a Strong and Comprehensive National Bill

While we believe that lenders can operate in the current regime of federal and state legislation, we would favor a strong national anti-predatory law if it is comprehensive and builds on the best state laws such as North Carolina's, New Mexico's, New Jersey's and New York's. It is remarkable that about half of the states in this country have passed anti-predatory laws. The anti-predatory laws that have been passed on a state level, however, have been uneven. While seven states have rigorous laws, several others have relatively weak laws that mostly mimic the federal Home Ownership and Equity Protection Act.[25] In the graph below, we calculate that only 19.7% of the population is

[25] The states with the strong laws are North Carolina, New Mexico, New York, West Virginia, Ohio, Massachusetts, and New Jersey.

currently protected by strong state laws. Thus, a comprehensive national law would provide uniform protection for citizens in all states if it expands upon the best state laws, does not weaken existing federal law, and also draws upon and codifies best practices established by industry.



CRA Modernization Must Accompany a National Anti-Predatory Bill

Building on the experience of our national coalition and state-level coalitions around the country, NCRC believes that a comprehensive anti-predatory bill must apply protections to a substantial number of subprime and non-traditional loans. At the same time that Congress is enacting an anti-predatory bill, NCRC also believes that Congress must pass the CRA Modernization Act of 2007, or HR 1289. HR 1289 would strengthen CRA as applied to banks and would apply CRA to non-bank institutions including independent mortgage companies. Federal Reserve research has demonstrated that CRA encourages banks to increase their prime lending, particularly in geographical areas in which their branches are located. CRA, therefore, acts to introduce product choice in traditionally underserved neighborhoods, meaning that these neighborhoods are less susceptible to steering and abusive lending.[26]

[26] Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data* in the Federal Reserve Bulletin, September 2006.

Provisions of an Anti-Predatory Bill

The protections in an anti-predatory lending bill must eliminate abuses during the application stage and mandate that loans are affordable, appropriate, and provide tangible net benefits to borrowers. The bill must also ensure that appraisals are conducted honestly and do not inflate home values. Finally, a bill must prevent servicing abuse. Through our CRF program and in our best practices dialogues with lenders, NCRC understands all to well how servicing abuse is not only disastrous for borrowers but can threaten the viability of financial institutions.

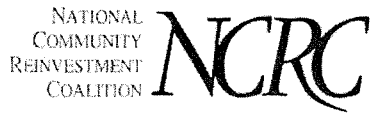
We are pleased that bills introduced in previous sessions recognize that a significantly greater number of subprime loans need to be covered with a federal anti-predatory bill than are currently covered by the Home Ownership and Equity Protection Act. Lowering the fee trigger to 5 percent is an appropriate and necessary trigger for extra protections. In addition, a federal anti-predatory lending bill must include charges paid to affiliates of lenders and indirect compensation received by lenders in calculating if points and fees exceed the trigger level.

The NCRC CRF case studies illustrate how abusive loans often involve fees in excess of 5 percent of the loan amount. In addition, Fannie Mae and Freddie Mac adopted guidelines as early as 2000 clearly stating that they will not purchase high cost loans with fees in excess of 5 percent. Major financial institutions in the industry have therefore recognized that loans with fees in excess of 5 percent are prone to abuses if not executed very carefully.

The following provisions must be included in any national anti-predatory bill. This list is not comprehensive, but covers critical features:

Points and fees – In addition to the provisions discussed above, a points and fees trigger should include prepayment penalties when the penalties exceed three years of duration and exceed a threshold in terms of a percent of the loan amount. A staggered schedule could be established in which prepayment penalties would be included in points and fees if they exceeded 3 percent of the loan amount in the first year, 2 percent in the second year, and 1 percent in the third year. Also, a threshold must be established for discount points to discourage excessive charges for discount points and ensuring that discount points meaningfully reduce the loan's Annual Percentage Rate (APR). Finally, compensation received by a broker and yield-spread premiums must be considered when calculating if points and fees exceed the trigger level.

Sudden Increases in Monthly Payments – Exotic mortgages can escape from the protections of an anti-predatory bill because savvy lenders can keep interest rates and fees below threshold levels triggering extra consumer protections. Congress must consider applying protections of an anti-predatory bill to loans that have sudden and significant increases in monthly payment amounts as a result of the expiration of teaser rates, interest only payment periods, and other features that keep payments artificially



low for an initial time period. A bill can establish a clear bright line such as extra protections apply if the monthly payment increases more than 25 percent or the result of the new monthly payment is that a borrower has a debt-to-income ratio higher than 50 percent.

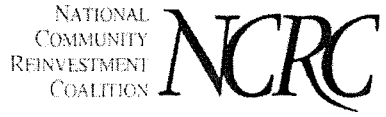
Steering – NCRC's data analysis and fair lending testing reveals that steering is a significant problem in subprime lending, and must be addressed in any bill. Borrowers, particularly borrowers in protected classes, are receiving high-cost loans when they actually qualify for lower cost loans. This can entail tens of thousands of dollars in extra costs for a borrower and can strip millions of dollars from communities when even a few neighbors experience price discrimination.

Prepayment Penalties – One of the first NCRC CRF cases involved a prepayment penalty that almost prevented a pre-foreclosure sale. In this case, not only was the original homeowner victimized, but all the usual stakeholders in a housing transaction (the buyer and real estate agent) also suffered harm. This example illustrates the damage that onerous prepayment penalties pose to the functioning of the housing market in minority and low- and moderate-income neighborhoods. Previous bills would prohibit prepayment penalties on all loans after 3 years, but many if not most subprime loans have prepayment penalties occurring in the time period between two and three years. Congress must carefully consider stringent limits to prepayment penalties between two and three years.

Financing Points and Fees – NCRC's CRF program reinforces the need to prohibit or limit financing points and fees so that loans do not become unaffordable. NCRC supports a prohibition on the financing of points and fees into high cost mortgages. At the very least, the predatory lending bills in previous sessions prohibited the financing of points and fees beyond 3 percent of the loan amount.

Repayment Ability – Previous bills stipulated that monthly debts, including mortgage payments, cannot exceed 50 percent of income, but the bills differed regarding allowing a consumer to affirm his or her income. The difference in required documentation is important. As NCRC's CRF program illustrates, "self-verification" procedures or stated income loans facilitate fraud and unaffordable loans since unscrupulous lenders will fabricate borrower incomes and then have unsuspecting borrowers sign the loan documents.

Single Premium Credit Insurance – NCRC believes that single premium credit insurance (SPCI) must be prohibited on all loans. At the very least, anti-predatory bills must ban the financing of single premium credit insurance (SPCI) and debt cancellation or suspension agreements on high cost loans and include SPCI in the definition of points and fees. These SPCI provisions should be straightforward because major subprime lenders have themselves discontinued single premium insurance products. Prohibiting these products on all loans would best protect consumers and insure that an industry best practice remains intact.



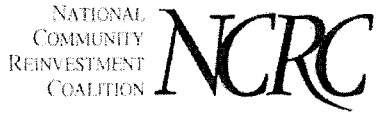
Flipping – An anti-predatory lending bill must establish a rigorous net tangible benefit standard and must avoid a series of safe harbors or exemptions that have the potential for enabling abusive refinancings. Under some previous anti-predatory lending bills, the NCRC CRF case example in California could be construed to be permissible. In this case, the refinance loan offered a tangible benefit of cash for various needs, but was clearly not a tangible net benefit to the borrower, considering that the high fees rendered the loan beyond the borrower's repayment ability. Any flipping language in a federal bill must be air tight and supported by a strong definition of a high cost loan.

Pre-Loan Counseling – NCRC supports pre-loan counseling modeled after the successful counseling requirement in the North Carolina anti-predatory lending law. In that state, a consumer is required to receive counseling by a counseling agency approved by public housing departments before a lender can issue a high cost loan to a borrower. A pre-loan counseling requirement is somewhat analogous to a home inspection conducted by an inspector of a customer's choice before the customer purchases a home. Home inspections have not burdened the real estate market and provide needed protections to consumers. Perhaps, a review by an independent third party should apply to all loans if the lending industry is concerned about singling out subprime loans. This would then make pre-loan counseling a regular and accepted procedure just like home inspections.

Mandatory Arbitration – An anti-predatory lending bill must prohibit mandatory arbitration. Major subprime lenders have given up on mandatory arbitration, meaning that a ban on mandatory arbitration should not be a contentious item in an anti-predatory bill.

Limits on Liability for Secondary Market - Currently, under federal law, a financial institution that purchases a high cost loan from a lender or broker is liable for all claims and defenses arising from violations of law. Applying liability for purchasers of loans is critical because a significant amount of subprime lending is conducted by brokers and mortgage companies who sell their loans to investors and financial institutions. Borrowers often have no recourse if the purchasers of loans have no liability.

Reporting to Credit Bureaus – Previous bills required lenders making high cost mortgages to report monthly borrower payment history to credit bureaus. This is a vital protection. Several years ago, former Comptroller of the Currency, John Hawke, raised alarms concerning lenders holding customers captive by not reporting their credit history. Comptroller Hawke pointed out correctly that consumers would have no way of proving their creditworthiness for lower cost loans if the credit bureaus did not have current information of their payment history due to lenders' withholding payment information. A requirement to report to credit bureaus will protect homeowner wealth by enabling borrowers to lower their interest payments and thus build up their equity faster.



Mortgage Servicers - An anti-predatory bill must apply protections against abuse by servicers of mortgages including force placement of insurance and failure to correct errors relating to payments. A bill must also require establishing escrows for payment of taxes and hazard insurance for high cost loans. NCRC's CRF cases include a number of instances where borrowers had trouble with unaffordable loans because they did not realize that their subprime loans did not have escrows.

Appraisal Fraud - Previous anti-predatory bills applied protections regarding appraisals for high cost mortgages, including physical inspections of the property and two appraisals in the case of two sales within 180 days of each other to protect against property flipping. The bills also prohibited lender influencing or intimidating appraisers. These provisions were encouraging, but we believe that they can be strengthened to address critical funding and staffing shortages of state regulatory agencies. In addition, the Appraisal Subcommittee of the Federal Financial Institutions Examination Council must be provided with meaningful oversight and enforcement powers regarding state regulatory boards.

Certification of Brokers and Mortgage Lenders Making Subprime Loans – A previous bill established certification requirements for mortgage brokers and lenders making subprime loans. This is an important step for establishing ethical conduct by lenders and reducing the amount of predatory lending. A national registry of brokers and lenders should be established that show which brokers and lenders are certified and which ones have lost certification. Many states have this type of registry revealing the current status of licensing for home improvement contractors; it is time to establish transparency for lenders and brokers.

Home Preservation Fund and FHA Role - An anti-predatory bill must establish a home preservation fund finance by Congressional appropriations and loan repayments. A good model is the State of Pennsylvania's Homeowners Emergency Mortgage Assistance Program (HEMAP). Perhaps the only program of its kind in the nation, HEMAP provides loans to borrowers experiencing temporary hardship (the loans make borrowers' mortgage payments current). Counseling agencies work out forbearance agreements with lenders and also counsel families regarding their financial situations. The program is funded by State appropriations and repayment of HEMAP loans. A federal anti-predatory bill should establish nonprofit community-based organizations as tbe recipient of home preservation funds since the non-profit organizations have the direct connection with homeowners experiencing financial distress. A national home preservation fund should assist borrowers facing default through no fault of their own.

FHA should also be re-tooled so that it can offer refinance loans on a large scale to victims of predatory lending. If FHA could offer these loans on a large scale, it could play a vital role in saving American's homes, reducing high delinquency and foreclosure rates, and saving communities from the devastation of widespread foreclosures and property abandonment.

Suitability Standard - A lively debate has emerged regarding whether an anti-predatory bill should contain a suitability standard imposing a fiduciary duty on lenders and brokers for recommending and making loans appropriate to borrowers' income levels and needs. The lending industry asserts that suitability standards are inherently subjective and will impede access to credit for minorities and low- and moderate-income borrowers. The argument that consumer protections curtail lending is a tired argument without merit if the protections are well designed. NCRC believes that an objective and reasonable suitability standard can be established. A fundamental flaw in today's lending markets is that the industry (including lenders, brokers, and secondary market investors) can escape the consequences of predatory loans through sophisticated secondary market transactions that effectively diversity risk and therefore minimize losses associated with predatory loans. Holding lenders, brokers, and secondary market investors financially accountable for inappropriate and unsuitable loans provides powerful incentives to lend responsibly.

Conclusion

NCRC's 600 member organizations strongly support the enactment of a comprehensive national anti-predatory lending bill and urge Congress to carefully craft a bill that truly serves the interest of consumers. We also believe that enactment of the CRA Modernization Act of 2007 and reviving the FHA program would increase prime lending and product choice in minority and working class communities. Strong leadership and decisive action must be taken to stop the epidemic of predatory lending. Every day, our member organizations struggle to assist families whose American Dream of Homeownership has been turned into nightmares of financial distress by predatory lenders. Thank you and I look forward to addressing all of your questions.

Consumer Federation of America

TESTIMONY OF

ALLEN FISHBEIN
DIRECTOR OF HOUSING AND CREDIT POLICY
CONSUMER FEDERATION OF AMERICA

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
OF THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

REGARDING

SUBPRIME AND PREDATORY LENDING: NEW REGULATORY GUIDANCE, CURRENT MARKET CONDITIONS AND EFFECTS ON REGULATED FINANCIAL INSTITUTIONS

MARCH 27, 2007

Good morning Chairmen Maloney, Ranking Member Gillmor and members of the Subcommittee. My name is Allen Fishbein, and I am the Director of Housing and Credit Policy for the Consumer Federation of America (CFA). I appreciate the opportunity to testify here today and we thank you for your holding this hearing to examine the problems of "Subprime and Predatory Lending: The New Regulatory Guidance, Current Market Conditions, and Effects on the Regulated Financial Institutions."

CFA is a national federation of some 300 pro-consumer organizations established in 1968 to engage in research, public education and advocacy in support of the interests of consumers. The goal of advancing sustainable homeownership is an important one for CFA and its members. For some time now, CFA has been concerned that the proliferation of non-traditional mortgage products in both the prime and subprime loan markets poses heightened risks for consumers. Indications are that many borrowers taking out these loans are not truly informed about their key features and the extra risks they entail. CFA has conducted consumer surveys along with other research and last year published a white paper on this topic. (See Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders.

This hearing could not be timelier. Turmoil in the subprime market brought on by rapidly escalating delinquencies and defaults has generated considerable public attention and concern. At last count, two dozen subprime lenders already have closed up shop, representing an estimated 15 percent of the industry and more may be on their heels. Investors world-wide have become jittery and there is talk that the problems in the subprime market may foreshadow problems to come for other segments of the mortgage market.

Thus this hearing is an opportune time to examine the sufficiency of steps that have been taken and whether additional action is warranted. The just proposed federal banking agency guidance regarding subprime lending should help to restore prudent underwriting for these loans. It should be adopted as quickly as possible and is much overdue. Speedy action also will be required by the states to adopt parallel guidance since the majority of the subprime loan market is under their watch. However, CFA believes that more focus should be directed at financial institutions, investors, government and the non-profit agencies to find creative solutions for keeping at-risk families who have been victimized by lax underwriting in their homes. The present environment also provides an opportunity to review the effectiveness of the present regulatory regime and determine the ways to improve the nation's consumer protection laws in this area.

My testimony makes three points to underscore what I have said above. First, changes to the mortgage market have contributed to the weak underwriting that has occurred in recent years and ultimately, to the greater risk exposure consumers now face; Second, I discuss why banking agency guidance should help, but further action by regulators still will be needed: Third, I discuss some ways that the current consumer protections laws can be strengthened.

1. The Face of the Changing Market and the Growth of Subprime Non-Traditional Lending

Homeownership can have many benefits, not the least of which is the opportunity it provides to build personal wealth. But these advantages are being eroded by the mass marketing of high-risk non-traditional mortgage products to many for whom they are not appropriate. What these loan products have in common is that they trade lower initial monthly payments for higher payments later that can escalate dramatically making loans unaffordable for unsuspecting borrowers. The abandonment in recent years by many lenders of careful underwriting based on the borrowers' ability to repay without refinancing or selling their home has made these loans even riskier.

Of particular concern are the hybrid adjustable rate mortgages (ARMs) that in recent years predominated the subprime loan market. The subprime market serves borrowers with weak or impaired credit who cannot meet the requirements for prime mortgages, whose rates typically are much lower. Subprime loans have been the fastest growing segment of the overall mortgage market.

Subprime hybrid ARMs typically feature initial short-term introductory rates (or "teaser" rate) for the first twenty-four or thirty-six months, which converts into an adjustable rate loan after that. Lenders maintained low teaser rates for these loans even after short-term rates began to rise, while increasing the amount the rate could adjust at the first reset period. Thus borrowers face exploding monthly payments of 30 percent or more even if interest rates did not rise. The concentration of hybrid ARMs among subprime borrowers has the additional risk of payment shock because they borrowers already are paying higher interest rates so subsequent increases are likely to be even more difficult to afford. As much as 80 percent of the subprime market has been comprised of these loans. In recent years, subprime borrowers have been qualified for hybrid ARMs based on their ability to repay under the lower teaser rate and not as the rate the loans adjusts to after the introductory period ends. The fact that layered risk elements, such as stated income, were used to loose underwriting standards for these loans.

Until about a year ago, rising home prices and relatively low interest rates made it possible for borrowers to refinance or sell their homes after the initial period ended or if they ran into trouble making payments. This served to mask the fact that many lenders were qualifying borrowers based on the loan's start rate. When home price appreciation leveled off last year delinquencies and defaults for these loans took off, rising to the highest levels in a decade.

And there are indications that the worse may be yet to come for borrowers holding these loans. The FDIC projects that 1 million ARMs are due to reset in 2007 and another 800,000 in 2008. The Center for Responsible Lending (CRL) modeled the performance of subprime loans and projects that one fifth (19.4 percent) of subprime borrowers over the past two years could enter foreclosure forcing 2.2 million households to lose their

homes and a loss of up to $164 billion in wealth. Another recent study using more conservative assumptions still estimated that fully 13 percent of the adjustable-rate mortgages originated through purchase or refinance from 2004-2006 will enter foreclosure.[1]

Defaults and foreclosures could surge even higher depending on the resiliency of the housing market and interest rate movements. Delinquencies usually rise when the housing market slumps because borrowers are more likely to encounter difficulties in selling their homes. In addition, if prices fall, borrowers may find themselves without the necessary equity to refinance into a more affordable loan.

The widespread use of "exploding payment" ARMs and other payment deferred non-traditional mortgage products points to fundamental concerns about whether consumers really understand just how much their monthly payments can jump with these and other deferred payment non-traditional mortgage products.

a) Evolution of the Subprime Market and the Emergence of Non-Traditional Products

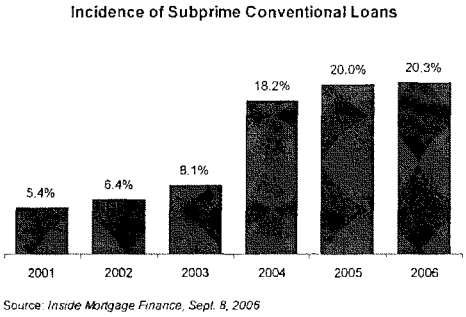
The subprime mortgage market serves those consumers who do not meet the credit standards to obtain a prime market. These loans typically feature higher interests rates and points and fees than prime mortgages, presumably to reflect the repayment risks these borrowers pose. Most subprime mortgages are refinance loans with borrowers using the collateral in their homes for debt consolidation and other consumer credit purposes. Subprime lending has grown rapidly as a segment within the conventional mortgage market.

The expansion of subprime lending has increased credit access for some, but prevalence of predatory loan practices associated with the growth of this market continues to raise important consumer protection concerns. Thirty states have adopted anti-predatory lending laws aimed at curbing abuses in the subprime market.

The "classic" predatory mortgage lending abuses entail excessively rates and points and fees, loan flipping (repeated refinancing), the packing of junk products, such as credit life insurance. Predatory mortgage loans typically also feature perverse market incentives, such as yield spread premiums and prepayment penalties, which reward mortgage brokers for increasing the loan price for borrowers. At its heart, predatory lending seeks to take advantage of the borrower's lack of understanding about loan terms, while often involving high pressure sales tactics, or even fraud.

[1] Cagan, Christopher, "Mortgage Payment Reset: the Issue and the Impact," First American CoreLogic, March 19, 2007.

Subprime loans are disproportionately marketed to racial and ethnic minorities and also to the elderly. They are also concentrated in minority and low income communities. Research by the Federal Reserve Board and others have found that risk factors, such as credit scores, loan to value and debt to income rations, cannot fully explain the disparities that exist in this market across consumer groups.



Subprime lending became more prevalent as the rapid rise in home price appreciation grew after 2000. Between 2001 and the first half of 2006, the share of conventional loans that were subprime mortgages nearly quadrupled from 5.4 percent of mortgages to 20.2 percent of mortgages in the first half of 2006.[2] Subprime ARM originations grew rapidly over the past half decade. Subprime ARM origination rose from $114.4 billion in 2000 to $213.7 billion in 2006 – an 86.8 percent increase.[3]

As recently as a few years ago, mortgages with non-traditional features were not commonly offered to borrowers with subprime creditworthiness. At the beginning of 2004, virtually no subprime borrowers received interest only mortgages but by July of 2006 almost 20 percent of subprime borrowers received interest only loans.[4] Simultaneous seconds also were a growing share of the subprime market. Subprime 2/28 hybrid-ARMs originated since 2005 were offered with a steep discounted teaser interest rate that will sharply rise by several hundred basis points for monthly payment increases between $300 and $500 – even if interest rate indexes remain flat.[5]

Particularly in recent years, lenders qualified more and more subprime borrowers for mortgages with layered risk characteristics including very low teaser-rates, low-documentation of income, and high loan-to-value ratios.[6] Additionally, low-documentation subprime lending grew. In 2002, the low-documentation lending made up 25 percent of subprime lending but it grew by 80 percent to 40 percent of the subprime lending in 2005.[7] In 2006, 50 percent of subprime loans were written to borrowers with

[2] Office of the Comptroller of the Currency, Response to Congressional Data Request from September 20, 2006 Hearing on Nontraditional Mortgage Products; data source, *Inside Mortgage Finance*, September 8, 2006.

[3] Orenbuch, Moshe and Kerry Hueston, Credit Suisse, "2007 Industry Outlook: Expect Some Bumps Along the Way," January 4, 2007 at 8.

[4] Walsh, Erin k., Wachovia Capital Markets, LLC, "Effects of Interagency Guidance on Home Equity ABS," October 30, 2006 at 2.

[5] FitchRatings, "2007 Global Structured Finance Outlook: Economic and Sector by Sector Analysis," December 11, 2006 at 21.

[6] England, Robert Stowe, "The Rise of the Private Label," *Mortgage Banking*, October 2006.

[7] Federal Deposit Insurance Corporation, "Breaking New Ground in U.S. Mortgage Lending," *FDIC Outlook*, Summer 2006 at 24.

low- or no-documentation of borrower income.[8] In 1999, almost no subprime borrowers used simultaneous second lien mortgages (thus enabling borrowers to purchase homes with little or no down payment), but by 2006 roughly a third of subprime borrowers also took out simultaneous second mortgages.[9]

b) Consumers Do Not Understand the Risk Associated with Risky Mortgage Products

CFA is concerned that many borrowers using mortgage products with built in payment shocks are not fully aware of the financial implications and potential hazards these loans entail. It is easy to understand why. Consumers today face a bewildering array of mortgage products that are marketed and promoted under a range of product names. While the number of products exploded, there appears to be too little understanding by borrowers about the key features in today's mortgages and how to compare or even understand the differences between these products. These problems are most severe for subprime loans which are often "push" marketed to borrowers who may not even be shopping for mortgage credit.

A 2004 Consumer Federation of America survey found that most consumers cannot calculate the payment change for an adjustable rate mortgage.[10] According to the survey, all respondents underestimated the annual increase in the cost of monthly mortgage payments if the interest rate rises from 6 percent to 8 percent by approximately 30 percent. Younger, poorer, and less formally educated respondents underestimated by as much as 50 percent.

The results of a recent Federal Reserve survey of ARM borrowers provides further indication that many borrowers are unfamiliar with even the basic terms of their mortgages. The survey found that 35 percent of them did not know the maximum increase that their interest rate can rise at one time, 44 percent were unsure of the maximum rate they can be charged, and 17 percent did not know the frequency with which their rate could change.[11]

Public Opinion Strategies, a nationally known polling organization, last year convened a focus group comprised of recent non-traditional mortgage borrowers. It also found that when consumers are shown the rate sheet with the various mortgage options they are surprised by the magnitude of the payment shock. Although upper-income focus group participants are less surprised, lower-income participants described the payment shock on the rate sheet as "shocking" and they were largely unaware of the size of the payment

[8] Miller, Derek, Mia Koo and Grant Bailey, FitchRatings, "U.S. Subprime RMBS in Structured Finance CDOs," August 21, 2006 at 4.
[9] Orenbuch, Moshe and Kerry Hueston, Credit Suisse, "2007 Industry Outlook: Expect Some Bumps Along the Way," January 4, 2007 at 8.
[10] CFA, "Lower-Income and Minority Consumers More Likely to Prefer and Underestimate the Risks of Adjustable Rate Mortgages," press release, July 26, 2004.
[11] Bucks, Brian and Karen Pence, Federal Reserve Board of Governors, "Do Homeowners Know Their House Values and Mortgage Terms?" January 2006 at 19.

shock.[12] These lower-income consumers were also less informed about the payment increases and debt risks of non-traditional mortgages, with some noting the "wish they had known more." The entire lower-income segment in one of the studied cities said that the higher payments after the mortgage recast would create a financial hardship for their families, and three quarters of them were concerned about their ability to make the monthly mortgage payments when the payments increased after the loan recast.

It is likely that this lack of knowledge has helped encourage borrowers to take out loans based on their initial repayment schedule without appreciating the possible risk of rising interest rates and increased monthly costs.[13] The lack of consumer understanding, especially among financially unsophisticated consumers, could set borrowers up to fail. Borrowers that do not fully appreciate the extent to which their notes will be recast or interest rates re-adjust will be ill-prepared to face the likely payment shock and could face losing their homes and their financial well being.

c) Concerns about Weaker Underwriting Standards and the Creditworthiness of Non-Traditional Mortgages

A basic premise in the mortgage lending industry has always been that adequate underwriting is necessary to protect the lender from loss. Indeed, evaluating the borrower's ability to repay the loan has historically been the basis for assurance against loss to the lender. Evaluation of the borrower's ability to repay the loan provides protections for both the lender and the borrower. It assures the borrower that someone schooled in the business of lending has determined that the borrower can afford to repay the loan. This underwriting process is essential for the borrower, who generally does not have the expertise to assess this question. However, in recent years the subprime mortgage industry has developed mechanisms to avoid the consequences of bad underwriting and still make substantial profits from mortgage lending. Neither the lenders nor the investors bear the risks that arise from the lack of underwriting or poor underwriting, as practical matter.[14] The industry and investors have developed a myriad of ways to protect themselves from themselves. The real risk of loss due to lender misconduct is now borne almost exclusively by the homeowner.

Risk to consumers is vastly different from risk to industry. Virtually all business risk can be protected against by a mortgage lender: more interest or fees can be charged on the loans, the servicing can be conducted in a more careful, and expensive, way, insurance against loss can be purchased, securitized pools of mortgage loans can be overcapitalized. It is all a matter of numbers and actuarial acumen to the lending industry. However, to consumers, some risks cannot be measured simply in dollars. The risk of losing one's home is a risk that most people do not want to gamble upon. It is not a risk that this

[12] *See* Fishbein and Woodall, CFA, "Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders," May 2006 at 21-21.
[13] Fahey, J. Noel, Fannie Mae, "The Pluses and Minuses of Adjustable-Rate Mortgages," *Fannie Mae Papers*, Vol. iii, Iss. 4, December 2004 at 2.
[14] *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending* (working paper 2006), available at www.ssrn.com (hereafter "Engel & McCoy").

nation's policies should foster. Yet, by allowing highly risky mortgages to be routinely made—mortgages which are known to have a very high chance of foreclosure—that is exactly what current mortgage policy does. Current policy permits mortgage products on the market that are known to lead to foreclosure for a substantial number of borrowers. While the lenders can protect themselves from the costs associated with those risks, consumers cannot reasonably do so.

The subprime mortgage industry has a business model of making loans that have a 20 percent chance of going into foreclosure within the first five years after origination, and a 60 percent chance of being refinanced.[15] Researchers have consistently marveled at the prevalence of refinancing of subprime mortgage loans, even when there are prepayment penalties present.[16] Despite the costs to the homeowners of these refinances, the lenders use this tool to transform a non-performing loan into a performing one.[17] These forced refinances are one way that the subprime mortgage industry ensures itself against loss: so long as there is sufficient equity in the home, regardless of the homeowner's ability to make the payments, there is unlikely to be a loss to the investor. Rather, because of the nature of the security – the family home – the debtor will go to great lengths to avoid that loss and will refinance, if at all possible.

The current structure of the regulatory environment for mortgage lending is based on the premise that efficient financial markets, with sufficient disclosures, and open access to choices, will produce equitable and appropriate products for consumers. Yet, as we have demonstrated, this is clearly not the case in the non-traditional and subprime mortgage market. Instead, the conversation continues to be about appropriately managing risk, *i.e.*, losses to the industry and investors, not losses to homeowners.

A recent article illustrates how the process of securitizing home mortgage loans facilitates the lack of underwriting – and thus the prevalence of predatory mortgages.[18] As the authors point out: "Wall Street firms securitize subprime home loans without determining if loan pools contain predatory loans."[19] This is the case because:

> [i]nvestment banks employ a variety of techniques, primarily structured finance and deal provisions, to shield investors from

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[15] *See* Roberto G. Quercia, Michael A. Stegman, Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, Kenan Institute for Private Enterprise, University of North Carolina at Chapel Hill, January 25, 2005. http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf. Tables 7 and 8. Each table shows that five years after a subprime loan with various characteristics typical in subprime mortgage loans (adjustable rates, prepayment penalty, balloon term), that loan would have over a 20 percent chance of being in foreclosure at some time in this five years, and a 60 percent chance of being refinanced in this five year period. Only approximately 19 percent of subprime loans were still in active five years after origination.

[16] *Id.* at Executive Summary.

[17] Vikas Bajaj, *Mortgages Grow Riskier and Investors are Attracted*, New York Times, *Sept. 6, 2006 at C1* (investors are increasing exposure in mortgage backed securities despite rising default rates and serious concerns by regulators about faulty underwriting in non-traditional mortgages).

[18] Engel & McCoy, *supra* note 16.

[19] *Id.* at 3.

> virtually all of the credit and litigation risk associated with predatory loans. Market and legal forces provide additional protections to investors.[20]

The mortgage industry protects itself from anticipated defaults and foreclosures by charging everyone a higher price, by securitizing loans in pools with less risky loans, and by adding credit enhancements.[21] That is fine as a business model for those in the mortgage industry. However, it is bad policy for this nation because it fails to account for the externality costs of the loss of homeownership and to communities into equation. The losses to the homeowner, the family, and the community from forced equity stripping refinancings and foreclosures are simply devastating.

2) New Federal Banking Agency Guidance is Helpful, but Additional Actions are Needed

Federal banking regulators in the past six months have taken two important steps to address concerns about high risk mortgage products. First, last October they issued in final form interagency guidance concerning certain non-traditional mortgage products that feature deferred monthly payments: interest only and payment option, negative amortizing mortgages. Second, federally banking regulators this past month issued proposed interagency guidance aimed more directly at subprime loan products with hybrid ARM features.

From the consumer's standpoint the most notable aspects of the October Non-Traditional Mortgage Guidance (October Guidance) is that it directs financial institutions to qualify borrowers at "the fully indexed rate (i.e., the rate in effect after the initial introductory rate expires) assuming a fully amortizing payment including potential negative amortization." In other words, borrowers should have the capacity to repay the full amount of the loan. Lenders also are instructed to consider the effect of substantial payment increase on the borrower's repayment capacity, and the importance of verifying a borrower's income. The Guidance also discourages lenders from using "collateral dependent" loans, which increase prospects for borrowers having to sell or refinance their properties once amortization begins. Regarding better consumer information, through this document federal banking regulators established an expectation for financial institutions they supervise to provide borrowers with disclosures about the relative benefits and risks of these products that are short, concise and timely. Model disclosures were offered for public comment as well, but have yet to be finalized.

CFA strongly supported prompt issuance of this regulatory policy. At the same time, we and others also pointed to its limitations. For one thing, as policy by federal regulators does not directly cover the many non-bank mortgage lenders that make the majority of mortgages. Thus we were pleased that the Conference of State Banking Supervisors

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[20] *Id.* at 3-4. It is pointed out later in the article that lenders are essentially indifferent to the deceit of mortgage brokers about default risks because they can shift the risk of loss to the secondary market. *Id.* ata 15 n. 52.

[21] *Id.* at 23-29.

(CSBS) and the American Association of Residential Mortgage Regulators (AARMR) immediately acted to develop parallel guidance for state regulators. We understand that to date 30 states have adopted the parallel guidance and others are well into the process. But, unfortunately, these include key states, such as California and New York, which means that there still are market segments not covered by the September Guidance. Uneven enforcement of the state standards could be a problem going forward.

Comments made by CFA and others noted additional limitations as well, such as the lack of consumer remedies and the fact that it does directly cover subprime loan activity (except if the subprime loans contained interest only or option payment features). We joined with many other consumer, community and civil rights groups in writing to the regulators and members of Congress to call for action on this subject.

Similarly, we are pleased that additional banking agency guidance for subprime loan products eventually was issued to address adequate underwriting of subprime loans with hybrid features. We believe it will help to improve underwriting of subprime and help to ensure that these loans are made only to those for whom they are affordable.

We commend, in particular, the leadership of FDIC Chair Sheila Bair and other FDIC board members, who in conjunction with other federal regulators worked so diligently to secure interagency agreement on this policy. We also commend the Congressional leaders, such as Chairmen Frank and Maloney, Chairman Dodd along with other members of his Committee members and to the Conference of Bank Supervisors who wrote to voice strong support for the need for this supplemental guidance. However, as with September Guidance, the subprime regulatory policy is highly dependent upon the cooperation of state regulators for it to have the desired impact. Their participation in adopting parallel guidance is particularly crucial for subprime lending, since the lenders and mortgage brokers they supervise and license represent the majority of these originations. Unfortunately, because of the nature of this regulatory process full implementation of this policy will take many months to achieve. Consequently, consumers in many states will continue to be at risk of receiving loosely underwriting hybrid ARM products from lenders until each state acts.

a) Federal Reserve Board Should Act to Use Statutory Authority to Ban Unfair and Deceptive Practices

There is another invaluable step the Federal Reserve Board can take to ensure a level playing field for all loan originators and to improve upon the limited consumer protections at the federal level. This would be to utilize its authority under the Home Ownership and Equity Protection Act (HOEPA) to prohibit unfair and deceptive mortgage lending practices. See Sec. 1639 (l) (2). Congress provided such authority for the Federal Reserve to use this authority with respect to all mortgage loans, not only loans covered under the HOEPA statute (closed end and refinance transactions).

b) *Government Sponsored Housing Enterprises Regulators Should Act to Implement Interagency Subprime Loan Statement*

CFA was pleased that the Office of Federal Housing Enterprise Oversight, the financial oversight agency for Fannie Mae and Freddie Mac, acted quickly to apply the Non-Traditional Mortgage Guidance to both housing GSEs. We would hope that recent adverse developments will encourage OFHEO again to apply this latest guidance to both of the GSEs.

Both GSEs' have been active in purchasing significant shares of securities backed by hybrid adjustable rate mortgages. We commend Freddie Mac's recent announcement that later this year it will discontinue investments in these loans. We hope that Fannie Mae will follow this course.

In the meantime, it should be noted that both GSEs have been receiving credit for these investments toward achievement of their statutorily mandated affordable housing goals. Given the poor performance of these mortgages and the prospects for high foreclosure rates we believe such activity does not warrant goals credit. The U.S. Department of Housing and Urban Development, which serves as the mission oversight regulator for the two GSEs, has sufficient regulatory authority to adopt rules that would disallow the GSEs' from receiving goals credit for mortgages whose underwriting has come under federal banking regulator scrutiny. We urge HUD to engage in the necessary rulemaking process to achieve these ends.

3) Conclusion: New Consumer Protections Are Needed

CFA believes that more has to be done to ensure that consumers are adequately aware of the financial risks associated with the complex and potentially exploding payment products being offered in the mortgage market. Yet the plain fact is that these products simply may not be appropriate for all borrowers who receive them. Thus, we offer these recommendations:

First, we believe that consumers must receive timely, clear, and balanced loan disclosures to help them make wise choices. Loan disclosures mandated under the Truth in Lending Act (and implemented by Regulation Z) should be revised and made more specific and more comprehensive. Borrowers should be provided with information about the maximum payment permitted under the contract. Yet improved disclosures are only a piece of the puzzle and, in and of them, are unlikely to be sufficient for many borrowers.

Nor do we believe that enhanced financial literacy alone is an adequate answer – the system is too complex and the bargaining power too diverse. Further compounding the problem is that many borrowers over-rely on loan originators to judge mortgage products for them even though mortgage brokers and lenders typically are not obligated to provide borrowers with the best loan. Industry best practices also are not an adequate answer. To the extent that some best practices can be agreed to, they are not enforceable by consumers and regulators cannot examine for them since they are not binding. Rogue

lenders can simply ignore them.[22] Regulation plays the important role of creating a level playing field for consumers and responsible lenders which does not countenance rogue players.

Second, tweaking the few federal laws that we have on the books that govern a small piece of the mortgage market – like the Home Ownership and Equity Protection Act (HOEPA) – is also not a complete answer. The mortgage marketplace has grown and developed in the 14 years since HOEPA was passed. The problems have become much worse. We need a more wholesale and comprehensive approach to protecting consumers seeking mortgage credit.

I. To maintain homeownership and to maintain the strength of home equity as a primary savings tool, the mortgage industry must be required to underwrite subprime mortgage loans to ensure that the loan is an appropriate loan for this household. To accomplish this, we need strong but flexible affirmative standards to apply to all mortgage loans. Congress should adopt a duty of good faith and fair dealing applicable to the non-traditional, hybrid adjustable rate and subprime market.[23] This duty would:

A) Require all originators to provide a loan which is suitable for the borrower's purpose based upon:

1) the borrower's circumstances, including the amount of other debt, the reliability of income, the expectations of changes in income borrower's age and plans and the number of dependents;

2) the borrower's objectives in obtaining the loan, such as the desire to lower payments, to pay off other debt, to reduce remaining term of loan, to reduce interest rate and to pay off loan early and to maximize home equity savings;

3) The borrower's ability to repay the loan, including the available income in the household, and the residual income after all debt is paid,

B) Require all lenders to consider the maximum payments possibly due under the loan, all of the borrower's reasonably anticipated expenses, and the borrower's actual residual income when determining the borrower's ability to repay the loan.

[22] Just one example of a set of the industry best practices which have been resoundingly ignored are those entered into by Ameriquest Mortgage Corp., which is the subject of a multi-district litigation proceeding in the Northern District federal court in Illinois. *See, e.g.* In re Ameriquest Mortgage Co., 2006 WL 1525661 (N.D.Ill.) May 30, 2006).

[23] A suggested definition of a subprime or "covered home loan" is provided in Section II of these comments.

C) Prohibit steering borrowers into costlier loans than the borrower's qualification would require.

II. All players involved in the mortgage loan must be part of the solution – just as they are now part of the problem – and there must be full assignee liability applied to mortgage loans. The industry and the secondary market all argue strenuously against assignee liability of any sort, citing, among other things, a series of terrible events that will befall the mortgage industry if full assignee liability is applied.[24] The best answer to all of these concerns is to look at what happened after 1975 when the Federal Trade Commission passed the *Preservation of Consumers Claims and Defenses Rule*.[25] That rule applies full liability in most circumstances to assignees of loans used to purchase goods and services. The automobile dealers and other sellers of goods, among others, argued that if the rule passed that the cost of credit would increase, credit would be more difficult to obtain, retail merchants would be hurt, financial institutions would stop purchasing consumer loans altogether, businesses would suffer, and many would be forced out of business altogether.[26] The finance companies and the banks argued that they did not want the responsibility of policing sellers and that sellers would not survive with the additional red tape, many consumers would stop paying on the loans without cause, and that the rule would interfere with free competition.[27] However, there are absolutely no indications that the passage of this FTC rule has had any impact whatsoever on the availability of or cost of credit. Indeed, it appears that credit availability has continued to expand since the passage of this rule.[28]

III. Congress should enact a duty of good faith and fair dealing in the making of appraisals to support home loans, requiring appraiser's bonds, and the prohibition of communication to the appraiser about the desired appraised value, and a procedure to rewrite the loan amount if a retrospective appraisal shows the original appraisal was inflated.

IV. Congress should establish a requirement of good faith and fair dealing in loan servicing, providing, among other things –

- Limits on fees and charges that can be assessed a homeowner after loan closing;
- Strict protections against the use of forced-placed insurance;

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[24] This "sky is falling" list includes – a dramatic decrease in the availability of credit, particularly effecting minorities; ruinous effects on small businesses; unfair burden on the secondary market to police loans as the process is so routinized and involves so many loans at any one time, that a careful review of each loan would be near impossible and would dramatically increase the cost of credit.

[25] 16 C.F.R. § 433, 40 Fed Reg. 53506 (Nov. 18, 1975).

[26] 40 Fed Reg. 53506, 53517 (Nov. 18, 1975).

[27] *Id* at 53518.

[28] In 1970, the total non-revolving credit in the US was approximately $124 billion; growth continued steadily through the 1970s and by December 1980, the total non-revolving credit in the US was approximately $297 billion. This growth continued notwithstanding the announcement and final promulgation of the holder rule. Source: Federal Reserve Statistical Release G.19 1970 through 1980.

- A comprehensive right to cure defaults – to avoid foreclosures;
- The requirement that alternatives to default ("work-out options") be evaluated before a foreclosure can be initiated.

V. Congress should establish a Home Preservation Loan Fund to be implemented by state housing finance agencies, which would provide money to homeowners for whom the payment of the mortgage arrearage would avoid a foreclosure, but who have the wherewithal to maintain their mortgage payments once the mortgage arrearage is paid. The funds for the payment of these arrearages would operate as "silent seconds," only required to be repaid once the first mortgage is paid off.

Borrowers with risky adjustable rate mortgages and nontraditional loans that will face steep payment increases over the coming year combined with the cooling housing market threaten to create a perfect storm that could significantly increase foreclosure rates over the next few years. The costs for this fall-out will be borne not just by homeowners, lenders, and investors but also by the communities where these loans are concentrated. Concentrated foreclosures can erode property values and put additional pressure on nearby homeowners who can see their home equity dissolve before their eyes leading to a cascade of neighborhood foreclosures. Policymakers at every level of government, the mortgage industry, and consumer and housing organizations all have a common stake in seeking workable solutions to mitigate this growing problem. The actions taken by these parties in the months ahead will determine much about whether homeownership continues to be a path for wealth building and financial stability for many borrowers.

We would be delighted to work with this Committee to frame solutions to help address these concerns.

Statement of John M. Robbins, CMB

Chairman of the Mortgage Bankers Association, Washington, D.C.

before the

Subcommittee on Financial Institutions and Consumer Credit
Financial Services Committee

United States House of Representatives

Hearing on

"Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Market Conditions"

March 27, 2007

Chairwoman Maloney and members of the Financial Institutions and Consumer Credit Subcommittee, my name is John Robbins and I am Chairman of the Mortgage Bankers Association (MBA).[1] I appreciate the opportunity to testify before you today as you review and consider issues related to the current state of the subprime mortgage market, the proposed statement affecting subprime hybrid ARMs, predatory lending and foreclosures. These are issues that are of central concern to the MBA and, with 36 years of mortgage banking experience, I am pleased to share industry's thoughts in these areas.

As we all are well aware, today's hearing is being held during a significant transition affecting subprime mortgage borrowers and the mortgage market. Let me start by saying that we all share the same commitment to assure that these borrowers continue to have the financing they need to buy and draw needed equity from their homes, and, most importantly, to stay in them.

We also share the same goal of developing better protections for consumers against abusive lending and foreclosures. When abusive lending happens, it is a stain on the mortgage industry just as it is a burden on our borrowers and communities. Foreclosures, likewise, are harmful and can be ruinous to both borrowers and to lenders as well. We do not and will not stand idly by while the dreams of our customers and the hard work of our industry are lost because of the excesses of a few.

In the wake of these events, we should not forget that the real estate finance industry has provided homeownership opportunities for the benefit of us all. It is the driving force in establishing communities, creating financial stability and wealth for consumers and fueling the overall economy. Our industry has helped our country reach a near 70 percent homeownership rate.

To meet these objectives, the industry has created an array of mortgage products to help borrowers get the financing they need to deal with record high house prices and to put home equity within their reach. Recently, however, because of an increase in delinquency rates, there have been claims that some of these products and financing tools are in themselves bad for consumers and have driven foreclosure rates to a state of crisis. This reaction overlooks the primary reasons for foreclosure namely employment loss, illness and other significant life events. Moreover, eliminating products will only take good financing options out of the hands of homeowners. The

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the Nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field.

effect will be to undermine our mutual goal of putting Americans in homes and keeping them there.

We believe the problem in today's subprime market was driven by a confluence of factors. These factors included over-capacity in the mortgage market, which the capital markets have swiftly responded to by tightening their guidelines. It was also driven by a drop in home price appreciation and an increase in unemployment. As a result of these and other changing market dynamics, the concern now is whether there will be adequate liquidity for borrowers who may be seeking to become first time homebuyers or are interested in refinancing adjustable rate products going forward. MBA and its lender members are committed to working with investors, advocacy organizations and others to serve these needs.

We strongly caution policy makers against any hasty action that could harm the very borrowers that we all wish to protect. In recent days, the market has changed the contours of many products. The regulators have issued new, comprehensive guidance related to nontraditional products and a proposed statement affecting subprime hybrid ARMs that will tighten underwriting of many mortgage products. The challenge now is to assure that credit is available.

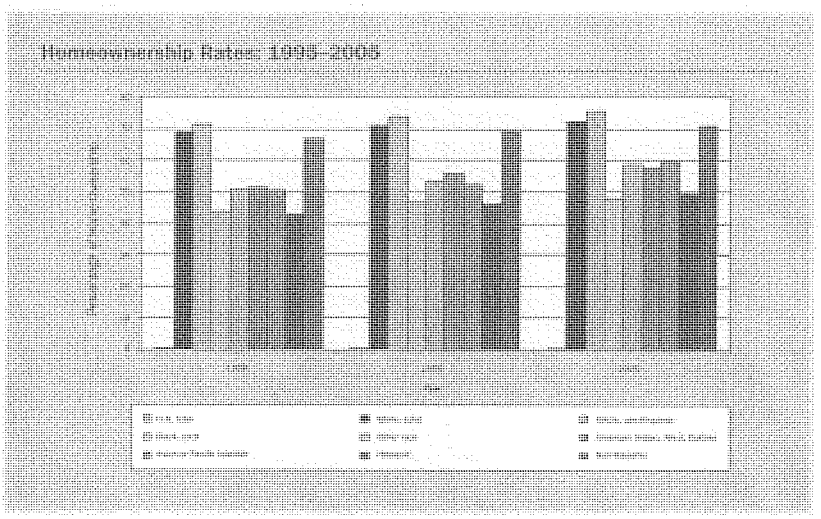
Going forward, MBA believes that in addition to assuring the availability of mortgage credit, there are three things the government can do to help protect consumers. First, make financial education a priority in this nation, empowering consumers with knowledge and giving them the tools they need to make good decisions and protect themselves. Second, simplify and make more transparent the mortgage process so that consumers may better understand the details of the transaction and facilitate shopping more efficiently from lender to lender. Third, enact a strong and balanced uniform national standard for mortgage lending with increased consumer protections.

MBA respectfully asks policy makers to continue to rely on sober judgment and sound research in assessing the scope of the problem and in considering legislative approaches that will affect this key area of the nation's economy. While there have been excesses and some bad actors in our industry, there are many, many more stories of lenders who have helped borrowers achieve and maintain their homeownership dreams.

MBA has considerable data that we will continue to make available. We urge government experts to carefully review it and to resist the urge to create policy based on headlines and anecdotes. The mortgage market in general has done an outstanding job for consumers and the larger economy and any policy that is not based on sound facts has the potential to undermine these benefits going forward – particularly for those in most need of credit.

I. TODAY'S MORTGAGE MARKET

Homeownership is near its highest level in history – nearly 70 percent overall. Homeownership rates rose roughly 3.5 percentage points in the U.S. between 1989 and 2001. Looking at recent years, in 2001, the overall homeownership rate was 67.8 percent. In 2006, it was 68.9 percent. For African-Americans, the rate in 2001 was 47.7 percent, and in 2006 it grew to 48.2 percent (although it was 49.1 percent in 2004). For Hispanics, the rate in 2001 was 47.3 percent and in 2006 it was 49.5 percent.



As a result of these increases in homeownership, across all demographics, Americans are building tremendous wealth by increasing their home equity through their monthly payments and through the impressive rate of home price appreciation seen in recent years. According to the Federal Reserve Board's (FRB) Flow of Funds data, the value of residential real estate assets owned by households has increased from $10.3 trillion in 1999 to $22.6 trillion as of the fourth quarter of 2006, and aggregate homeowners' equity now exceeds $10 trillion. According to the FRB's 2004 Survey of Consumer Finances, the median net worth for homeowners was $184,000. For renters, it was $4,000.

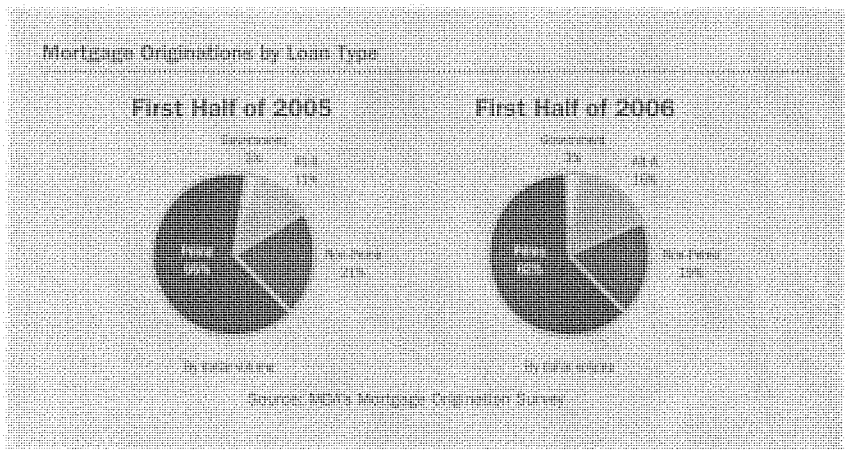
More than a third of all homeowners own their homes free and clear of any lien. Of the remaining two-thirds of homeowners who do have mortgages, three-quarters have fixed rate mortgages. Only one quarter of these borrowers, or about a sixth of all homeowners, have adjustable rate mortgages (ARMs).

Homeowning Household Distribution
By Mortgage Type

Household Mortgage Type	Percent	Percent of Those with a Mortgage
No Mortgage	34.6	
Fixed Rate	49.2	75.2
Adjustable Rate	16.2	24.8
Jumbo	3.9	6.0
Conforming	12.3	18.8
Total	100.0	100.0

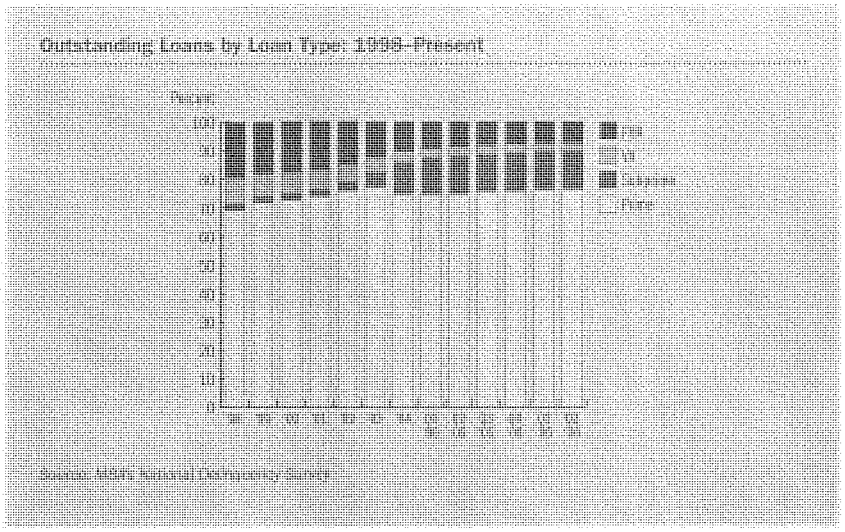
Source: American Housing Survey; Mortgage Bankers Association

According to MBA's Mortgage Originations Survey, in the first half of 2006, 62 percent of the dollar volumes of loans originated were prime loans, 16 percent were Alt. A, and 19 percent were nonprime, with government loans accounting for the remaining 3 percent.



Estimates from MBA's National Delinquency Survey (NDS) indicate that the number of nonprime loans has increased more than 6.5 times over the last five years (Q4 2001 to Q4 2006).

Based on first half 2006 data, nearly half of nonprime borrowers, or 45 percent, utilize nonprime loans to buy homes. One in four of these purchases was made by a first-time homebuyer. Also, notably, over the last several years the average difference between the interest rates of prime loans and non-prime loans has decreased markedly.



II. MORTGAGE PRODUCT INNOVATION – Creating Access and Affordability

As we have indicated, the mortgage industry takes pride in its innovations in developing mortgage products. Innovation in combination with the liquidity provided by the secondary market has dramatically expanded the opportunity for consumers to become homeowners, particularly for traditionally underserved borrowers.

Over the past several decades, as mortgage lenders have sought to adapt to changing market conditions and changing consumer preferences, mortgage products have developed beyond the 30-year, fixed-rate, amortizing mortgage. In fact, in the early 1980s, in response to prohibitively high interest rates, the ARM began to gain wide acceptance.

In addition to ARMs, some lenders at the forefront of responding to consumer demand for product diversity, particularly in high cost markets, began to offer interest-only and payment-option mortgages. Mortgage lenders have successfully offered such products for decades, through different market cycles, without threatening their safety and soundness. It is therefore prudent to look to the practices of lenders regarding nontraditional mortgage products rather than imposing overly prescriptive requirements that would force them to change proven standards, disadvantaging institutions from effectively participating in this market.

Over the last decade, hybrid ARMs, where the initial interest rate is fixed for a period of time and then adjusts annually, also have gained wide acceptance in response to consumer demand. Through these products, borrowers now can take advantage of hundreds of different financing options based on their individual needs and circumstances. They can also choose among thousands of mortgage originators. MBA supports the opportunity for consumers to make their own choices. Consumers are in the best position to choose which mortgage option is best for them and their families.

A. Nontraditional Mortgage Products

"Nontraditional mortgage products" refer to financing options which have been developed to increase flexibility and affordability and otherwise meet the needs of homebuyers who have been purchasing homes in an environment where real estate prices have increased faster than borrowers' incomes. Other homeowners have used these products to tap their homes' increased equity for a variety of needs including home improvements and renovations, paying down other forms of debt, as well as education and healthcare needs. While these products have often been characterized as "new," some of them actually predate long term fixed-rate mortgages. Nontraditional mortgage products include fixed- and adjustable-rate loans that permit interest only (IO) payments and payment-option loans including option ARMs.

MBA strongly believes that the market's success in making these "nontraditional" products available is a positive development. Although these products have been used to finance a relatively small portion of the nation's housing, they have offered and continue to offer new, useful choices for borrowers.

Notably, however, while nontraditional products have offered borrowers a variety of options, many of these products are not prevalent in the nonprime market. Payment-option loans are typically not available in the nonprime sector. In fact, according to Fitch Ratings, no nonprime loans carried a negative amortization feature in 2005. The IO share in the prime sector was 44 percent of dollar volumes, while it was 25 percent of dollar volumes in the nonprime sector. According to Standard & Poors, nonprime IO borrowers tend to have larger loans, typically indicating higher incomes, and better credit scores than nonprime borrowers who choose other products.

To be sure, as with all mortgage products, nontraditional mortgages must be underwritten by lenders in a safe and sound manner and their risks must be appropriately managed. As with other products, loan originators must provide consumers necessary information on a product's terms so a borrower can determine whether the product matches his or her needs and financial abilities.

Reports by MBA members and other data reviewed by MBA indicate that interest-only and payment-option mortgage borrowers also generally have good credit scores and relatively low loan-to-value (LTV) ratios. These products also tend to be most prevalent in higher cost areas of the country where there is a greater need for affordability products. For example, California, a particularly high cost state, has always had a high

ARM share. As the risk of a loan or its features increase - mortgage lenders take appropriate steps to offset the risk by requiring other features like higher credit scores to ensure a borrowers credit worthiness.

Interest-Only and Payment-Option Mortgages:

Interest-only and payment-option mortgages are two different products. Each is treated differently by lenders in terms of credit policy, underwriting standards and risk management.

An interest-only mortgage is commonly a loan under which a borrower is permitted to make interest-only payments for a certain period of time, after which the borrower is required to make principal payments as well. The interest rate may be fixed or adjustable during the interest-only period and may be fixed or adjustable after amortizing payments are required. Borrowers are typically allowed at their option to make principal payments during the interest-only period.

A payment-option mortgage is a loan for which a borrower typically has an option each month to make one of four payments: an amortizing payment based on a 15-year repayment schedule; an amortizing payment based on a 30-year repayment schedule; an interest-only payment; or a minimum payment based on a start rate which is below the fully-indexed accrual interest rate.

Where the minimum payment is insufficient to pay all of the interest due at the accrual interest rate, negative amortization occurs. Negative amortization means that the principal balance owed by the borrower increases. Typically, the minimum payment is fixed for 12 months, after which it adjusts annually based on the fully-indexed rate. Payment increases are usually limited to 7.5 percent in any one year. The amount of negative amortization may range from 10 to 25 percent of the original mortgage amount; if this limit is reached, the loan is recast, requiring payments that will amortize the outstanding balance over the remaining term of the mortgage.

B. ARMs and Hybrid ARMs

ARMs, including hybrid ARMs, significantly differ from interest-only and payment-option products and are not covered by the nontraditional guidance. As explained below, on March 7, 2007, the Federal financial regulators published a Proposed Statement on Subprime Mortgage Lending that, among other things, would cover hybrid ARMs.[2]

ARMs, first developed in the 1970s, permit borrowers to lower their payments if they are willing to assume the risk of interest rate changes. Hybrid ARMs, introduced in the mid-1990s, combine the benefits of fixed rate mortgages and adjustable mortgages and allow borrowers to opt for a lower initial interest rate and lower monthly payments, which are fixed for a period of two to ten years (including 2-28 ARMs and ARMs with longer fixed payment periods). After the fixed payment period ends, the hybrid ARM converts

[2] Proposed Statement on Subprime Mortgage Lending, 72 Federal Register 10533 (March 7, 2007)

to an adjustable rate mortgage with the interest rate and payments adjusting periodically (usually yearly) based on interest rate changes in the capital markets.

ARMs, including hybrid ARMs, are not simply refinancing tools; these mortgages are affordable financing and for some borrowers credit repair options that have helped millions of borrowers achieve the dream of homeownership. Hybrid ARMs offer a lower monthly payment during the fixed payment period than a fixed rate mortgage. Nearly half, or 45 percent, of nonprime loans are purchase loans, with 25 percent of nonprime purchase mortgages originated for first-time homebuyers indicating that a significant portion of the recent gains in homeownership are likely attributable to hybrid ARMs. In the first half of 2006, 67 percent of new subprime loans were ARMs.

Data available to MBA from large member companies indicate that for the 30 percent of hybrid ARM loans that borrowers refinance with their companies, 50 percent of these hybrid ARM borrowers refinance into a prime loan half of which are fixed, half of which are ARMs. Of the remaining 50 percent of borrowers, 25 percent refinance into fixed rate subprime products and 25 percent refinance into other ARMs

Hybrid ARMs are frequently underwritten using more flexible guidelines based on reasonable repayment expectations, allowing many more borrowers to qualify for these loans. Flexible underwriting for hybrid ARMs is appropriate. Relatively few hybrid ARMs experience any adjustment at all; hybrid ARMs are usually refinanced very early in their terms. Data from Fitch Ratings indicate that of the prime loans originated in 2003, only 44 percent remained outstanding as of the second quarter of 2006. For subprime loans originated in 2003, only 22 percent remain outstanding as of that time.

If ARMs and hybrid ARMs also are required to be underwritten at the fully-indexed rate, as the guidance proposes (see below) then we must face the fact that many hybrid ARM borrowers simply will not qualify for mortgages to buy homes or to get needed credit. For many borrowers, the choice is not between an ARM and a fixed rate mortgage to finance the property they want; it is an ARM or no mortgage at all.

Hybrid ARMs are not "exploding mortgages." Payment increases are generally much smaller than alleged and by virtue of borrowers moving or refinancing, frequently never come due. The rates and payments under hybrid ARMs do not normally increase by 40-50 percent, after the option period has expired, as has been alleged. In fact, whether there are any payment increases depends on the structure of the ARM and what happens to interest rates during the fixed period of the loan. Data from lenders demonstrate that today, on average, the change between the average start rate and the average fully indexed rate under these mortgages is generally no more than 2-3 percentage points. To protect borrowers from unmanageable payment increases, lenders structure hybrid ARMs so that there is a cap on the periodic adjustment. Also, as indicated, most subprime borrowers do not remain in their mortgages for more than three years. In any event, the potential increase in payments for borrowers later in the life of a hybrid ARM pales by comparison to the initial up-front savings to these borrowers.

C. Federal and State Guidance

1. Nontraditional Guidance

On September 29, 2006, the federal financial regulators including the Board of Governors of the Federal Reserve (FRB), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA) jointly issued Final Guidance on Nontraditional Mortgage Products (the Guidance).[3] Key aspects of the guidance are the same as the proposed guidance issued for comment by the regulators nearly nine months ago, with a few significant clarifications.

The Guidance addresses risks posed to federally regulated financial institutions by the growing use of mortgage products that allow borrowers to defer payments of principal and, sometimes, interest. The guidance specifically covers interest only (IO) and payment-option adjustable rate mortgages (Option ARMs). It specifically excludes home equity lines of credit (HELOCs) and reverse mortgages.

The guidance applies to federally regulated institutions including federally chartered banks, savings and loans and credit unions but it has a "trickle down" effect since it requires such institutions to monitor the quality of third party originations so they reflect the institutions' lending standards and compliance with laws and regulations.

The Guidance addresses three sets of concerns: (1) Loan Terms and Underwriting Standards; (2) Portfolio and Risk Management Practices; and (3) Consumer Protection Issues.

On November 14, 2006, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) encouraged the states to adopt guidance which generally tracked the Federal Guidance and, to this end, both organizations published their template as CSBS/AARMR Guidance. This guidance is based on the Federal Guidance, and only modified or deleted those provisions dealing with risk management that were inapplicable to non-depository institutions.

In their press announcement, the organizations noted that consistent guidance "will allow the opportunity to gauge the impact on the mortgage market and consumer behavior." As of this date, 29 states and the District of Columbia have adopted or begun the process of adopting the CSBS/AARMR guidance.

Mortgage lenders have been subject to a patchwork of lending requirements, in areas other than nontraditional products, emanating from the federal, state and even local governments. These diverse standards, while well-intentioned, have lessened competition, increased regulatory costs and, thereby, increased costs to the consumer.

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[3] 71 Federal Register 58609 (October 4, 2006)
http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/attachment1.pdf

Restrictions that vary from locality to locality lessen the number of entrants that are willing to learn and comply with particular requirements. Increased regulatory risks and compliance costs for those who do compete translate into increased costs for consumers.

For this reason, MBA particularly appreciates the efforts of the regulators to develop guidance that is consistent among federal and state regulated institutions. Consistency of guidance better serves consumers, increases competition and lowers costs.

2. Proposed Statement on Subprime Lending

On March 7, 2007, the federal financial regulators including the Board of Governors of the Federal Reserve (FRB), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration (NCUA) jointly proposed for public comment a Statement on Subprime Lending (Statement).

The Statement addresses several items including: nonprime loans with a fixed introductory rate that expires after an initial period and then adjusts to a variable index rate plus a margin; low documentation loans; "payment shock;" product features likely to result in frequent refinancings; prepayment penalties; and loans made with inadequate information to the borrower concerning material terms and product risks including the borrower's obligations for taxes and insurance. The Statement proposes guidance for federally regulated institutions regarding risk management and underwriting, control systems, consumer protection for these loans as well as plans for supervisory review. The Statement also poses several questions for comment including whether it should be extended beyond the subprime market and the effect of its underwriting provisions on borrowers due for a reset of their loan's rate.

Notably, the Statement proposes to require that in qualifying borrowers for nonprime ARM loans meeting the foregoing criteria, institutions should evaluate the borrower's ability to repay the debt by final maturity at the fully indexed rate. It also provides that the higher a loan's risk either from a loan's features or borrower characteristics, the more important it is to verify the borrower's income, assets and liabilities. The Statement reminds institutions of necessary consumer protections including warnings about payment shock, balloon payments, taxes and insurance and prepayment penalties.

While MBA plans to offer comments on various provisions of the guidance and does not believe that it should be extended beyond the subprime market in these terms, MBA strongly supports the regulators efforts. We believe it is appropriate that the regulators provide guidance for subprime borrowers in light of the demands of these consumers for these products as well as concerns about pending resets considering current data. We also strongly support the fact that the regulators have sought comments on the new Statement. Through this process industry, advocacy organizations and borrowers themselves can offer their views to refine the scope of the proposal. Finally, we

appreciate the stated intent of CSBS and ARMR to issue parallel guidance in this area, as well to assure consistency bringing greater protections and lower costs to consumers.

3. Underwriting Standards

The establishment of underwriting standards is ordinarily the responsibility of lenders and mortgage investors who are constantly refining credit policies in response to risk analysis, market conditions, and consumer behavior. Mortgage lenders have successfully offered nontraditional as well as hybrid ARM products using credit reports, credit scores, and sophisticated modeling to ensure that the features of nontraditional loans are mitigated with features that reduce risk. While recent information assumes that some lenders and investors have developed products that have resulted in unsatisfactory delinquency levels, it is far too early to fully assess the extent of this problem is. It is clear though that the capital markets have responded through changing the guidelines and underwriting standards of the products in which they will invest. Current credit options have become much more conservative.

While MBA and its members agree that borrowers should not be underwritten at teaser rates that are substantially below the fully-indexed accrual rate and are in effect for just the first few months of the mortgage, MBA has not favored the establishment of rigid, overly broad, underwriting standards that require analysis of borrowers' ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. We have commented that such an approach is far too prescriptive and forces lenders to apply credit policies that disadvantage products in a manner which is inconsistent with their risks.

The nontraditional guidance expects that interest-only and payment option mortgages be underwritten to the fully indexed rate, a result that will limit the availability of these products. The extension of this requirement to hybrid ARMs will have a similar effect. Moreover, under an approach requiring underwriting to the fully indexed rate, a 10/1 hybrid ARM with a 20-year amortization starting in year eleven would be disadvantaged against a 3/1 hybrid ARM with a 27-year amortization starting in year four despite the fact that most lenders would consider the 10/1 hybrid ARM a lower risk product.

Key risk factors of a hybrid mortgage include the initial length of time during which the interest rate is fixed, where an interest-only payment is required or the fact that the loan does not amortize. An overly broad standard may require lenders to invert this risk analysis and treat loans with a longer fixed rate or payment timeframe as higher risk than those with shorter timeframes.

MBA would caution that if the policy decision is to require underwriting of hybrid ARMs to the fully indexed rate going forward, any such policy must be flexible enough to ensure that all borrowers facing a reset will have access to credit to refinance. To that end, MBA is committed to consultations with Wall Street, the government sponsored enterprises and advocacy organizations to assure that credit is available. We cannot

allow the current tightening of credit to strangle borrowers who, but a few days ago, could easily refinance.

4. Portfolio and Risk Management Practices

MBA and its' members share the view embodied in the guidance that lenders should pay particular attention to those products in their portfolios that carry higher risks and change credit policies and risk management practices when performance problems arise or risk analysis indicates there might be a problem.

There is also agreement with the requirement that mortgage lenders should have appropriate controls in place for the types of mortgage products they originate.

Day-in day-out, lending institutions work internally and with their regulators to ensure that their loan loss reserves are adequate given the risks in their portfolios.

5. Borrower Information Concerning Nontraditional Products

MBA and its members strongly believe that the features of mortgage products offered to consumers should be fairly represented so that consumers can decide for themselves which product makes the most sense given their personal financial position. Many consumers understand the array of products and have used them appropriately to their advantage.

Because there is no single, uniform, mandated disclosure for nontraditional products, lenders have developed their own disclosures to inform borrowers about the characteristics of these products. Many mortgage lenders have been originating these products for a considerable amount of time and have significant experience with them. This experience has informed the development of disclosures.

Lenders also provide borrowers the range of information and disclosures mandated under the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA), including the Consumer Handbook on Adjustable-Rate Mortgages (CHARM) booklet.

MBA has reviewed the disclosures developed by several MBA members who originate significant volumes of nontraditional mortgages and have found them to be quite detailed and comprehensive in providing consumers the information they need to fully understand the mortgage product they are considering.

Mortgage lenders that successfully offer these products constantly review the performance of these loans. They make changes as warranted to credit policies and other practices, including disclosures, to improve performance and to facilitate customer understanding.

MBA and its members have also embarked on what we think is a groundbreaking, new effort called Project Clarity. This effort will establish simple, plain English documents to be provided to all borrowers at the earliest possible time when they are shopping for a mortgage. First, we developed them, and now at the expense of the industry, we have begun testing them around the country in focus groups. We also plan to seek the input of the members of this subcommittee and your staff, regulators and consumer groups. The draft disclosures are still under review and testing and we anticipate having them out by this summer. We want these important documents to help our customers as quickly as possible.

MBA appreciates the efforts of the Federal regulators to issue Proposed Illustrations of Consumer Information on Nontraditional Products published contemporaneously with the federal nontraditional product guidance and we strongly urge the regulators to use the existing authorities under TILA to improve disclosures for nontraditional products nationwide.

The regulators determined that new information as set forth in the Proposed Illustrations could not await a more comprehensive approach to disclosure as suggested by MBA in its comments on the Guidance. The regulators concluded that guidance was needed now, to ensure that consumers get the information they need about nontraditional products. There is a similar point of view respecting the products covered by the Statement. While MBA supports provision of all necessary information, we urge the regulators regard the new disclosure illustrations as a temporary approach. MBA recommends that the regulators direct their energies toward a much more comprehensive approach of improving the mortgage disclosure process for consumers and require the provision of these disclosures from all mortgage lenders.

Consumers today confront a pile of disclosures when they apply for and close on a mortgage. Sadly, every new layer of disclosure simply increases the likelihood that the consumer will merely initial all of them without even a cursory reading. For this reason, the number of disclosures need not increase, rather, they need to be combined, streamlined and made much more user friendly.

Efforts at improvement should include all disclosures required by federal law. Because RESPA and TILA apply to regulated and unregulated entities, such an approach is the best means of assuring that virtually all consumers receive high quality information and that a level playing field of disclosure requirements is established for all industry originators. These efforts should also consider the plethora of state disclosures.

MBA strongly believes that sound underwriting, risk management and consumer information are essential to the public interest. We also believe it is essential that the legislative and regulatory environment foster innovation in the industry to assure that borrowers confront a competitive marketplace offering low cost credit options. Such an environment allows lenders to provide borrowers the widest array of options to purchase, maintain and, as needed, draw equity from their homes to meet the demands of their lives.

III. THE PRIMARY REASON FOR DEFAULTS ARE EMPLOYMENT, FAMILY AND ECONOMIC DIFFICULTIES – NOT PRODUCT CHOICES

There is no evidence that product choices by borrowers are determinative of defaults or foreclosures. Different products have different default rates but the product choice does not cause the default. Data consistently demonstrate that delinquencies among all borrowers are a function of a variety of factors including, first and foremost, economic difficulties caused by job losses. According to Freddie Mac, based on a sample of loans in Workout Prospector®, from 1999 to 2005, the following sets out the reasons for delinquency:

Reasons for Delinquency

Variations in delinquencies from state-to-state reflect differences in the level of unemployment:

Unemployment or curtailment of Income	41.5%
Illness or Death in Family	22.8%
Excessive Obligation	10.4%
Marital Difficulties	8.4%
Extreme Hardship	3.3%
Property Problem or Casualty Loss	2.1%
Inability to sell or rent property	1.6%
Employment Transfer or Military Service	0.9%
All Other Reasons	9.0%

The impact of employment on loan performance is illustrated in a comparison between Arizona and Michigan for the fourth quarter of 2006. The foreclosure inventory rate for subprime hybrid ARMs in Michigan was 11.39 percent and in Arizona it was1.66 percent during this period. At the same time, unemployment rates in Michigan were 7.2 percent and 4.15 percent in Arizona. The increased unemployment rate corresponds to the increased foreclosure rate in Michigan and vice versa in Arizona.

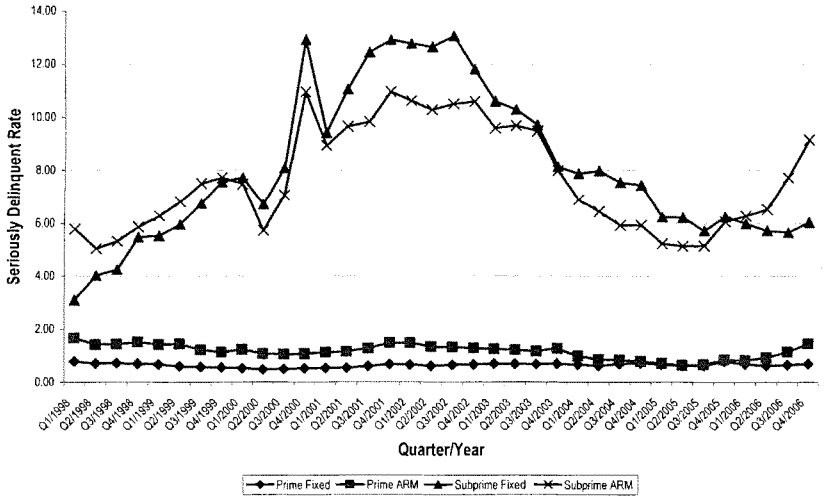
The chart below sets out a comparison of the top five states that have the highest and lowest delinquencies across all loan categories including subprime ARM, subprime fixed, FHA, prime ARM and prime fixed. The same three states – Ohio, Michigan, and Indiana – make the top five states with the highest delinquencies all in five categories. It also happens that these three states have significant unemployment problems. It can not be denied that there is a causal relationship between employment and homeowners ability to make their mortgage payments.

Subprime ARM		Subprime Fixed		FHA		Prime ARM		Prime Fixed	
Highest Five:									
Ohio	19.03	Ohio	13.05	Michigan	10 70	Ohio	3.89	Ohio	1.95
Michigan	17.70	Indiana	10.68	Ohio	9.43	Oklahoma	3.82	Indiana	1.76
Indiana	16.70	Michigan	10.60	Indiana	8.06	Indiana	3.74	Michigan	1.29
Iowa	15.21	South Carolina	9.17	South Carolina	7.73	Michigan	3.63	South Carolina	1.25
Kentucky	13.08	Pennsylvania	9.09	Georgia	7.51	Iowa	2.79	Kentucky	1.20
US Total	**9.16**		**6.04**		**5.78**		**1.45**		**0.69**
California	**5.67**		**2.48**		**2.05**		**0.87**		**0.17**
Lowest Five:									
Hawaii	4.74	Oregon	2.22	Idaho	2.15	Washington	0.59	Wyoming	0.21
Washington	4.49	Arizona	2.10	California	2.05	Oregon	0.57	Montana	0.19
Utah	4.08	Wyoming	2.10	Montana	1.85	Arizona	0.53	California	0.17
Oregon	3.78	Hawaii	1.91	Wyoming	1.52	Idaho	0.53	Hawaii	0.13
Arizona	3 08	Alaska	1.17	Alaska	1.37	Hawaii	0.49	North Dakota	0.11

Seriously Delinquent loans defined as 3 or more payments late plus loans in foreclosure
Excludes Louisiana and Mississippi

While overall delinquencies rose in the fourth quarter of 2006, assertions that delinquency rates are at crisis levels and a greater percentage of borrowers are losing their homes are not supported by data. In fact, delinquency and foreclosure rates have remained relatively low with increases over the last year. The chart below traces delinquencies from 1998 through the fourth quarter of 2006. It reveals the fact that delinquencies were higher in the subprime market at the end of 2000 as well as during 2002 than they were in the fourth quarter of 2006.

Chart 8. Seriously Delinquent Rate by ARM & Fixed



The delinquency rate for mortgage loans on one-to-four unit residential properties stood at 4.95 percent of all loans outstanding in the fourth quarter of 2006 on a seasonally adjusted basis up 28 basis points from the third quarter, and up 25 basis points from one year ago, according to MBA's National Delinquency Survey (NDS). All ARM loans had higher delinquency rates as compared to the third quarter of 2006. Delinquency rates for in the fourth quarter increased 33 basis points for prime ARM loans (from 3.06 percent to 3.39 percent) and increased 122 basis points from subprime ARMs (from 13.22 percent to 14.44 percent). The delinquency rate for prime fixed loans increased 17 basis points (from 2.10 to 2.27 percent), while the rate increased 50 basis points for subprime fixed rate loans (from 9.59 percent to 10.09 percent).[4]

MBA's fourth quarter 2006 NDS found that the percentage of loans in the foreclosure process was 1.19 percent, an increase of fourteen basis points from the third quarter of 2006, while the seasonally adjusted rate of loans entering the foreclosure process was 0.54 percent, eight basis points higher than the previous quarter. The foreclosure inventory rate for subprime loans in the fourth quarter of 2006 was 4.53 percent up from 3.86 percent in the third quarter. The foreclosure inventory rate for prime ARMs went from 0.70 percent in the third quarter up to 0.92 percent in the fourth quarter, for non-prime ARMs from 4.68 percent to 5.62 percent. The foreclosure inventory rate increased for subprime fixed rate mortgage loans it went from 3.00 percent to 3.19 percent.

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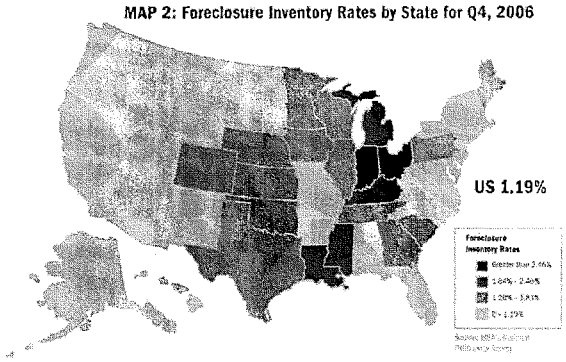
[4] These figures are based on MBA data. MBA defines "delinquency" as having one or more payments overdue. The loans in foreclosure are approximately a third of these numbers and the borrowers actually losing their homes are approximately a fourth of that group.

MAP 2: Foreclosure Inventory Rates by State for Q4, 2006



In its most recent data, MBA is seeing increases in delinquencies and foreclosures for nonprime loans, particularly nonprime ARMs. Because of technology induced cost reduction and efficiency gains by the industry as well as the appetites of borrowers for credit, the share of outstanding loans that are nonprime has been increasing for the last several years. The higher average delinquency and foreclosure rates among these loans mean the overall statistics for total outstanding mortgages are unlikely to fall as low as in the past.

It is important to note that nonprime loans have always had higher delinquency and foreclosure rates and lenders factor in these risks when lending to nonprime borrowers. Given the fact that nonprime borrowers have weaker credit profiles, this is not surprising. Foreclosures also can be accelerated by slow housing markets that limit borrowers' ability to quickly sell in order to cover their losses. MBA data has indicated that over the last several quarters a number of factors, including the aging of the portfolio, increasing short-term interest rates and high energy prices, have been putting upward pressure on delinquency rates.

Nevertheless, for each borrower whose loan goes into default and is foreclosed, the experience is a traumatic one, and it is not surprising that counsel for such borrowers would assert every claim available to permit their clients to hold onto their homes.

However, policymakers need to understand that keeping the homeowner in their home paying on their mortgage is the best outcome for both the lender and the borrower.

IV. FORECLOSURE PREVENTION AND SERVICING PRACTICES

Mortgage servicers want to preserve homeownership and, in fact, have economic incentives to get borrowers back on their feet as quickly as possible and avoid foreclosure. Delinquencies and foreclosures are costly both from a hard and soft dollar perspective. Significant staff must be dedicated to handling delinquencies and foreclosures. Servicers also must advance principal and interest payments to investors and pay taxes and insurance premiums even though such payments are not received from the borrower. If the loan becomes seriously delinquent, servicers must hire foreclosure attorneys and pay for property preservation. All these costs can be a significant drain on capital. In the event of foreclosure, noteholders take significant losses on the loans. A 2003 Federal Reserve study notes that, "estimated losses on foreclosures range from 30 percent to 60 percent of the outstanding loan balance because of legal fees, foregone interest, and property expenses." [5] From a pure economic basis alone servicers do not desire foreclosures.

It is important to note that servicer profits derive from receiving the servicing fee for administering the loans. Although the servicing fee is small, usually amounting to one fourth of one percent of the loan balance, when a loan is delinquent, that fee is not earned. When a loan is extinguished through foreclosure, the servicing asset represented on the balance sheet is also extinguished. Large numbers of foreclosures are detrimental to a servicer's earnings and net worth. Thus, long-standing claims that lenders knowingly put borrowers into products they cannot afford in order to take the property through foreclosure are simply unfounded.

In reality, everyone loses in a foreclosure – the borrower, the local community, the mortgage insurer, investors and the servicer. Lenders and servicers do not have incentives to cause foreclosures, because profitability rests in keeping loans current and, as such, the interests of borrowers and lenders are aligned.

A. Loss Mitigation Tools

Recognizing the significant downside to foreclosures and with a strong desire to assist their borrowers, servicers have, over the last 15 years, made deliberate and significant strides to provide workout alternatives to foreclosure. These alternatives include both home retention options, such as forbearance, repayment plans and modifications, and home relinquishment options when the borrower can no longer support the debt. Of course, servicers strive to provide home retention solutions whenever possible. The following is a brief overview of the home retention options used by servicers. The availability of these options is dependent on investor agreement.

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[5] Foreclosing on Opportunity: State Laws and Mortgage Credit, Karen M. Pence, Board of Governors of the Federal Reserve System, May 13, 2003.

- **Forbearance Plans:** These plans provide postponements in payments with a typical duration of six months, followed by repayment of the arrearage over time. The plans can be verbal or written.

- **Delinquent Refinances:** Although less common, borrowers that are less than three months behind may be able to refinance to lower rates and capitalize the arrearage.

- **Subordination of Unpaid Debts:** Servicers in some cases can also place the arrearages into a junior lien in order to bring the loan current. The borrower is required to pay both debts, similar to a repayment plan, but this option makes such payments more affordable because the balance owed is amortized over a longer period of time.

- **Temporary Modifications:** These modifications allow for a temporary reduction in interest rate or payments for a period of time, usually lasting about six months.

- **Permanent Loan Modifications:** These modifications result in permanent changes to one or more of the original loan terms, such as the interest rate and/or duration of the loan. A permanent modification is a very effective work out vehicle, because it provides an immediate resolution to the delinquency by taking the amount of arrearage and adding it to the balance of the modified loan (e.g. "capitalize the arrearage") and re-amortizing the payments. The duration of the loan can also be extended to reduce monthly payments. While this option gives the borrower and loan servicer additional choices, its availability is limited for those mortgages that have been purchased by investors in the form of mortgage-backed securities. Because the MBS are held in trust, rules restrict servicers and trustees from altering the assets.

  Two-thirds of all mortgage loans are placed in trusts to create mortgage-backed securities and then the MBS are sold to investors. Trust documents dictate what the servicer is permitted to do in the way of loss mitigation. In many cases the servicer is prohibited from modifying the loan. In other documents the servicer is permitted to follow standard industry practices—a very vague standard that could create liability for the servicer if there is a subsequent challenge from some investor group. Subprime and other private label servicers have had moderate success in amending the investor documents, but such changes require the approval of all investors. There can be many investors in an MBS trust and locating the beneficial owner investor can be difficult or impossible. Under some circumstances, the MBS trustee has to seek a legal opinion that modification of delinquent loans will not affect the securities' REMIC tax status. This is costly and there is a risk that the IRS will have a different opinion and terminate the REMIC. Such a result would be financially catastrophic for the MBS investors because the loss of REMIC status results in taxation of the trust as a corporation and not as a pass-through entity. This means that the income from the MBS

would be taxed at both the trust entity level and the investor level, rather than just at the investor level.

Non-home retention loss mitigation alternatives are useful when borrowers have no viable means to cure their financial situation. These options offer several benefits that should not be discounted. First, they avoid foreclosure which can severely impact the borrower's credit. Second, the servicer generally does not seek repayment of the deficiency, which is the difference between the value received for the property and the amount of the debt owed. Third, borrowers are often assisted with moving expenses. These options are most often used when home prices decline below the amount of outstanding debt:

- **Pre-Foreclosure Sales (PFS) or Short Sales:** Proceeds from a third party sale of the borrower's home are accepted as satisfaction for the mortgage, even though they represent less than the amount owed.

- **Deeds-in-Lieu of Foreclosure (DIL)**: The borrower voluntarily deeds the property to the servicer as satisfaction for the mortgage even though the value of the property is less than the amount owed.

B. Servicer Practices

Before borrowers ever reach the point of being seriously delinquent, servicers attempt to cure the delinquency. Experience has shown that early intervention is the key to curing delinquencies. As a result, servicers make significant attempts to contact borrowers early in the delinquency or even before a delinquency occurs. In fact, prime lenders have adopted some techniques from subprime lenders that have proven effective, including: providing welcome calls to new customers ensuring that they have important contact information; initiating reminder calls prior to the expiration of the grace period for at-risk borrowers; using automation to determine when a borrower's failure to make a payment is outside of their normal pay-behavior; and prioritizing out-bound assistance calls to the highest risk delinquent borrowers first. This allows servicing staff to focus their resources where they are most needed. These techniques have proven to be beneficial for consumers. In addition to personal contact, servicers send numerous notices to borrowers informing them of their delinquency, offering loss mitigation and providing helpful information on how to avoid foreclosure. Property preservation personnel in some cases also leave discrete information at the property address.[6]

[6] The following are the notices/solicitations typically provided by servicers: a payment reminder that payment is past due (from 2-16th) (this is typically for high risk borrowers); late charge notice notifying the customer that payment is past due and late charge has been assessed; monthly account statement reflecting either the current and/or total amount past due; notice of availability of counseling and state/local payment assistance programs at 45 days (Federal Law); mail "How to Save Your Home" pamphlet at 60 days (Federal Law for FHA loans); mail internally created documents on how to save the home for non-FHA loans; separate letters soliciting for loss mitigation; multiple calls each month to solicit alternative collection/loss mitigation. Additional notifications are sent pursuant to state statutory requirements or preconditions to foreclosure including the breach (or demand letter); letter announcing acceleration of the debt; service of process notices, and foreclosure sale date.

Some servicers are also using telecommunication tools to streamline contact with delinquent borrowers. Through automation, the delinquency status of in-bound callers can be determined very quickly and calls routed automatically to workout staff thus by-passing the company's standard customer service line. The process is seamless to the consumer and avoids wait times. Other companies provide dedicated toll-free numbers that go directly to the loss mitigation teams trained to address more complex borrower needs.

Servicers have also developed web sites that allow borrowers to access loss mitigation information, obtain and submit required documents and in some cases apply for loss mitigation online.

Unfortunately, despite all this technology and effort, over half of borrowers in foreclosure proceedings have had no contact with their servicer.[7] This lack of contact is one of the biggest challenges servicers face in trying to cure delinquencies.

One situation that MBA believes contributes to this low contact rate is a provision in the Fair Debt Collection Practices Act (FDCPA). Under FDCPA, a lender who purchases servicing on a delinquent loan is required to announce itself as a "debt collector" prior to discussions with that customer. A servicer who purchases current servicing that subsequently becomes delinquent, however, is not required to make this announcement. This so-called "mini Miranda warning" effectively drives borrowers away by creating a misleading and conflicting message with loss mitigation efforts (especially when servicers request financial information from the borrower for purposes of structuring the loss mitigation plan). Servicers that purchase delinquent servicing should be treated like other servicers and not have to provide this statement.

Even with these obstacles, servicers are not just throwing in the towel. They are proactive in exploring new options that bring borrowers to the table - ways that create approachable environments for borrowers who might be embarrassed or not trusting of the lender. This includes teaming up with non-profit and for-profit agencies to assist in *locating* borrowers and providing homeownership counseling.

Counselors work with borrowers and their servicers to achieve and execute loss mitigation arrangements. The hope is that homeowners who are hesitant to call their servicers will be more likely to contact a non-profit organization or other reputable intermediary to discuss alternatives.

The paradigm has shifted from a decade ago. Borrowers need to know that lenders can help. A direct call to the lender or to a reputable housing counselor can save a borrower's home. We hope to convey that message whenever possible.

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[7] Foreclosure Avoidance Research, Freddie Mac, 2005.

V. THE IMPOSITION OF A SUITABILITY STANDARD HURTS THOSE IT IS MEANT TO HELP

As indicated, the data does not show that unsuitable products or predatory lending are the cause of delinquencies and foreclosures. The foreclosure problem is based on economic difficulties that confront borrowers.

Notwithstanding, a number of advocacy organizations have urged that a "suitability standard" be imposed on mortgage lenders as a means of making the lender responsible for assuring the borrower is in the right loan to prevent foreclosure later. These organizations assert that a "suitability standard" applies to securities brokers and that there is no reason why a similar standard should not be imposed on mortgage lenders. MBA disagrees.

While a specific proposal for a "suitability standard" for the mortgage industry is not yet fully formed, a variety of approaches have been suggested. Most would simultaneously require more rigid, prescribed underwriting standards, a duty of fair dealing at the inception of the loan, a subjective evaluation by the lender whether a product is best suited for that borrower, the establishment of a fiduciary obligation by the lender to the borrower and a private right of action to redress any violations. Some suggest that a regulator be empowered to specify the parameters of the requirement. While many of these points might sound good at first, on closer examination of the facts, they each raise very significant concerns for consumers.

Earlier this year, MBA published a paper that explains why the imposition of a "suitability standard" on the mortgage lending industry risks unintended, negative consequences for consumers that would turn back the clock on hard won fair lending and homeownership gains. Congress should resist pressure to enact a suitability standard for the mortgage lending industry and, instead, should turn its attention to the creation of a uniform national lending standard. A uniform national standard would be the best approach to addressing the current mortgage market challenges.

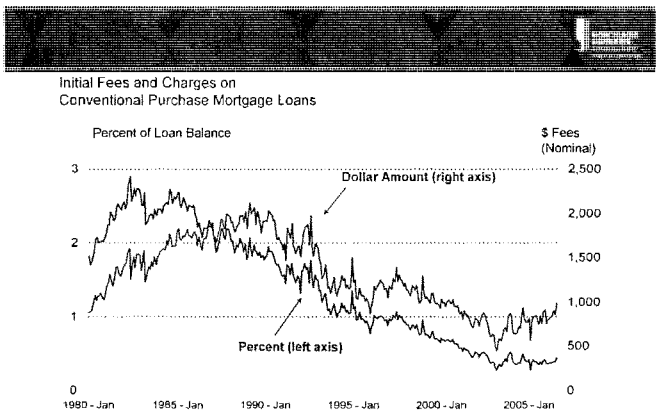
A. Rigid Hard Wired Underwriting Standards Deny Credit Options to Borrowers

The most recent data provided by the mortgage lending industry under the Home Mortgage Disclosure Act (HMDA), on loans made in 2004 and 2005, demonstrate the greatest and widest availability of mortgage finance in our nation's history, which in turn has made possible record homeownership rates. The data show that borrowers in virtually every area of the nation, of every race and ethnicity, and at every income level receive an unparalleled array of credit opportunities.

It is important to remember how we got to this point. The confluence of several factors has contributed to the growth in credit opportunities for prime and nonprime borrowers over the last 15 years. These factors include increased competition from an unparalleled number of loan originators including mortgage companies, banks, credit

unions and mortgage brokers. They also include innovations in the mortgage market, resulting in the range of mortgage products available today including fixed-rate products and adjustable rate products as well as "nontraditional."

Most importantly, the past 15 years has been marked by dramatic changes in the mortgage origination process made possible by technology. Computerization has enabled a much greater understanding of default risk and the development of objective underwriting criteria. It has also permitted the embodiment of these criteria in automated underwriting tools and the growth of risk-based pricing. As shown in the chart below, according to the Federal Housing Finance Board's data from their Monthly Interest Rate Survey, the costs of originating a mortgage have declined tremendously both measured as a percentage of the loan balance and in nominal dollars.



Source: Federal Housing Finance Board

Risk-based pricing, in turn, has permitted the development of a market to serve the needs of nonprime borrowers "who have difficulty in meeting the underwriting criteria of 'prime' lenders because of blemished credit histories or other aspects of their profile."[8]

Rigid new underwriting standards, no matter how well intentioned – even as innocuous as requiring a particular debt-to-income ratio, for example – will result in denying some borrowers' credit who would otherwise qualify in today's market. Some of these borrowers will even be denied homeownership although they would qualify today. The

[8] Remarks by Governor Edward M. Gramlich at the Federal Reserve Bank of Philadelphia, Community and Consumer Affairs Department Conference on Predatory Lending, Philadelphia, Pennsylvania (December 6, 2000).

magic of today's market is that the widest range of borrowers can get the widest spectrum of loans.

Similarly, while it might sound reasonable to require that all borrowers contending for a hybrid adjustable rate mortgage (ARM) that allow lower fixed payments for an initial period and higher payments after that be qualified at the fully indexed rate, such an approach will lock some borrowers out of the home of their dreams and deprive them of lower payments. It would also have the consequence of failing to allow these borrowers an opportunity to repair their credit so they can refinance into a lower priced prime loan before the rate adjusts. Moreover, ARMs, allow borrowers to allocate more of their cash flow to other uses. For example, a borrower who saves on their mortgage payment can put more funds towards financial investments, potentially diversifying their overall portfolio.

Some insist that a borrower who can not meet fixed ratios should be denied credit if they don't satisfy a particular test. Such a result is unnecessary in today's financing world. Also, respectfully, MBA wonders if that opportunity should be withheld from 87 percent of borrowers, including those who qualified for non-prime loans who are making their payments and achieving the dream of homeownership.

Today, borrowers at virtually all points on the credit spectrum qualify for loans. The imposition of new rigid standards would change that.

B. The Imposition of a Suitability Standard Risks Unintended Consequences

While certainly not intended to promote or authorize discrimination or reignite redlining, MBA is extremely concerned that the injection of subjective standards into the mortgage process would conflict with and potentially threaten fair lending, community reinvestment and homeownership gains particularly for first time homeowners and minorities.

The reason this would happen is not because anyone has bad motives but because new subjectivity would be injected into the market, the risks would increase markedly, driving many lenders to be much more cautious or even to withdraw from the market. Lessened competition and increased risks will decrease financing options and increase costs.

Since the 1990's, the denial rates of African-American loan applicants, though still greater than white borrowers, have declined considerably. In 1992, the denial rate for conventional home purchase loans for African-American borrowers was 36 percent and in 2004 it was 24.7 percent. While there has been some increase in the institutions covered by HMDA over these years, the number of applications nearly quadrupled over this period.[9]

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[9] 1992 and 2004 HMDA data.

Although all homeownership has increased since the 1990s, the percentage increase in African-American homeownership has been greater than among whites and the national average. The African-American homeownership rate has increased almost six percentage points since 1994, while the overall rate has increased nearly five percentage points. If a subjective suitability standard is imposed, in the first instance, lenders will be required to assure that a loan is suited for the borrower. If such a standard is imposed, a lender facing a mortgage applicant who is a member of a protected class, and for whom a loan product may be "unsuitable," might deny the borrower credit options to conform to the suitability requirement and, at the same time, violate the letter and spirit of fair lending and community investment requirements. Conversely, if credit is extended, the lender risks violating a suitability requirement.

Either way, by injecting ***subjective*** standards into the process, there will be much greater caution by lenders and less competition in the market as lenders shy away from these risks. There is real concern that subjectivity and even caution will disproportionately affect first-time homeowners, minorities and those with less wealth where suitability and fair lending concerns intersect.

Even if the facts suggest that a lender is in compliance with both fair lending rules and a suitability requirement, borrowers who go into default are likely to claim that the loan was "unsuitable." This new cause of action will also drive lenders out of markets, lessening the availability of credit and driving up costs for consumers. It would seem that only the lawyers will benefit.

Although as indicated, advocacy organizations point to the securities industry as a model for a suitability standard, on examination, the industries are not analogous. Their business models differ and so do the policy imperatives that govern them.

While federal policy has been to encourage mortgage lenders to make credit available to as many borrowers as possible, by contrast those responsible for regulation of the securities industry have not made expansion of investment opportunities to underserved persons or neighborhoods a major policy initiative. The consequence of the suitability requirement for a securities firm is that overly cautious broker-dealers will lose out on commissions. The consequence of a suitability requirement for mortgage lenders is that overly cautious lenders may violate the letter of federal anti-discrimination laws and the spirit of community reinvestment laws.

As far as their business models are concerned, securities broker-dealers function as intermediaries between their customer and the market to invest their customers' money; broker-dealers hold themselves out as investment consultants. Mortgage lenders, on the other hand, represent their companies and investors whose money they put at risk to make loans to borrowers; they do not function as agents or fiduciaries and they do not hold themselves out as such to borrowers. Consumers select their securities advisor on a long-term basis, but regularly shop among mortgage lenders when seeking a mortgage.

It is noteworthy that survey data indicates that an intrusion by lenders into the borrower's personal decisions is unwelcome by the borrower whom a suitability standard would be designed to protect. One recent study found that 88 percent of respondents would prefer to "decide for themselves whether or not a mortgage product is right for them, rather than leaving that responsibility to the mortgage lender."[10]

Also notably, borrowers subject to a pilot program in the City of Chicago that imposes mandatory financial counseling only for borrowers in specific ZIP codes have filed a law suit alleging that the program amounts to "state-sanctioned redlining."[11] Governor Blagojevich suspended this law on Friday, January 19, recognizing that it was hurting the people it was designed to protect, according to *The Chicago-Sun Times*.[12]

Lenders can and do offer valuable information to consumers. Lenders help consumers understand what mortgage products are available and for what mortgages they might qualify. For this reason, it pays for consumers to see lenders early in the home buying process, not only to determine what property they can afford, but also to consider their financing choices in relation to their particular situations, including their incomes, credit and plans to stay in their homes. Nevertheless, lenders cannot serve as agents and fiduciaries for borrowers as well as for their own companies.

Despite the wide range of market innovations, some borrowers have obtained loans with terms that negatively impact their ability to repay. Let us assure you, the fundamental goal that borrowers only obtain loans they can repay is shared by consumers, advocacy organizations, regulators and mortgage lenders alike. For this reason, the mortgage lending industry has a great stake in striving, along with advocacy organizations, legislators and regulators, to make the lending process as understandable and abuse-free as possible and more work is needed toward this goal. However, imposing a suitability standard is not an appropriate solution and would run the risk of turning back the clock on innovations that have greatly expanded home ownership opportunities.

Congress, therefore, should resist pressure to enact a suitability standard which would harm consumers. Retaining the current "arms length" transaction model in the mortgage lending industry works best.

VI. STEPS CONGRESS CAN TAKE TO PROTECT CONSUMERS

There are at least three things Congress can do to help consumers become better informed through the mortgage process, protect themselves and help them make the best choice for themselves.

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[10] *See* American Financial Services Association Press Release, "Borrowers, Not Lenders, Should Decide Appropriateness of Mortgage Products, Finds Survey," (Nov. 20, 2006).

[11] *See* Mary Umberger, "Home Buyer Counseling Challenged," Chicago Tribune, Nov. 2, 2006.

[12] *See* Lisa Donovan, "Gov Halts Mortgage Counseling," Chicago Sun-Times, January 21, 2007.

First, considerable resources should be committed to improving borrower education to raise the level of financial literacy, including incorporating this issue into general educational programs and increasing access to transaction-specific borrower counseling. It would be a worthy undertaking to conduct a review of total government efforts in the area of financial literacy to see what is working is what is not. This study could also include the amount of resources expended for this purpose. MBA believes that better financial education would empower all borrowers to shop effectively among the array of competitors in the marketplace.

Second, simplification of the mortgage process and all necessary consumer information would make it much easier for an empowered consumer to navigate the market, and such improvements are long overdue. Consumers today face a pile of disclosures when they apply for and close on a mortgage. Efforts at improvement need to streamline the existing mandated disclosures and information, and must be comprehensive and well considered. A successful effort would result in much more effective information on the benefits, costs and features of the loan options presented by lenders. It would also go a long way to help borrowers shop for mortgages among lenders with an ability to make an apples-to-apples comparison.

Third, uniform lending standards that are clear and objective, but do not unduly restrict the market, would improve on the standards established under HOEPA to stop lending abuses. These standards must be national in scope to enhance competition in all markets for all borrowers, especially nonprime. Such standards will allow all borrowers to benefit from greater choices, competition and lower prices that a fair and fully functioning market brings. MBA would support the expansion of the types to loans to be covered in a uniform national standard to include purchase money loans and open-ended lines of credit.

MBA supports the framework for a national standard that includes the following principles and components.

Broad Principles of a National Standard:

- Uniform National Standard. A national law should recognize a national mortgage market by including broad preemption that facilitates competition and market efficiencies leading to low cost mortgage lending. It should apply to all lenders creating uniformity in the market. It should not change the current regulatory oversight, preemption or enforcement regime of those regulated by the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC).
- Protect Financing Options. The innovation of lenders to make mortgage credit more widely available through a variety of products and financing tools should be

protected. Unduly limiting or outlawing finance options could put homeownership out of borrowers' reach, particularly underserved borrowers.

- Risk-based Pricing. Lenders' ability to efficiently price loans based on the risk of non-payment presented by a borrower has revolutionized and expanded the availability of mortgage credit. Through risk-based pricing, mortgage credit is more widely available to borrowers, especially to traditionally underserved communities. A national standard should recognize and protect the benefits of risk-based pricing.
- A Suitability Standard Should Not Be Imposed. Certain groups have suggested imposing a suitability standard on mortgage lenders. Lenders already make a "suitability" determination through assessing affordability when underwriting a consumer's ability to repay a loan. A suitability standard beyond that threatens progress made in fair lending as well as the availability and affordability of credit to homeowners by reintroducing a subjective determination into a loan officer's work. Further, the imposition of a suitability standard exposes lenders to significant liability and will increase the cost of mortgage credit since it could affect the mortgage-backed security marketplace.
- Objective Standards. The provisions of any national standard passed by Congress should include clear, objective standards so that consumers understand their rights and protections and lenders understand compliance requirements.
- Added Consumer Protections: MBA supports increased protections for consumers in a national standard.

Components of a National Standard:

A. HOEPA Triggers:

- Reasonable High Cost Loan Triggers. Almost no lenders will make loans that meet the HOEPA high cost loan triggers because of the significant liability that attaches. Investors will not buy high cost loans because of the liability, which dried up liquidity for these loans. The triggers, therefore, act as a de facto usury ceiling in that lenders won't make loans above the triggers. Therefore, the APR and point and fee triggers should be maintained at their current levels so that legitimate lending is not cut off. MBA would support the setting of triggers at a reasonable level to help assure that mortgage credit continues to be available to credit-worthy borrowers.
- Point and Fee Definition Should Not Be Overly Broad. A national standard should maintain the items included in HOEPA for making the point and fee calculation. Neither prepayment penalties, nor yield spread premiums should be included in the definition because doing so would threaten the use of these finance options and because the value of those items is already reflected in the interest rate and APR. Thus, including those items in a points and fees test would result in double counting. Lowering the point and fee trigger by excessively expanding the point and fee definition will invariably cut off legitimate credit to our neediest borrowers.

B. HOEPA Protections:

- Refinancing a Loan Should Provide a Benefit to a Borrower. Existing loans should not be refinanced into a high cost mortgage loan unless doing so provides a benefit to a borrower. A national standard should allow regulators to establish objective safe harbors for determining when the benefit threshold is met.
- No Asset Based Lending. Evaluating a borrower's ability to repay a loan is fundamental to a lender in underwriting a mortgage application. A lender has every incentive to ensure a loan is properly underwritten since the lender takes the risk of loss on a defaulting loan and, through agreements with investors, can be forced to repurchase a loan from the secondary market. A borrower's ability to repay a high cost loan should not be solely based on the collateral value of the property.
- Assignee Liability. MBA supports the maintenance of the existing assignee liability regime provided in the Truth in Lending Act (TILA) and HOEPA.

C. Consumer Protections for All Loans:

- Prepayment Penalties Should Be Limited to Three Years. Prepayment penalties reflect an agreement between the lender and borrower whereby the borrower agrees to stay in a mortgage for a period of time in exchange for a lower rate or a significant reduction in fees. If a prepayment penalty is offered, it should be limited to three years and clearly disclosed to the borrower.
- Yield Spread Premiums Are a Valuable Financing Option. A yield spread premium (YSP) is a very good mortgage financing option that allows borrowers to pay closing costs through the rate. The inability to use yield spread premiums could bar creditworthy borrowers from homeownership. Where RESPA requires it, MBA would support improved YSP disclosures.
- Borrowers Should be Given Choice to State Income. Stated income loans are important to certain borrowers, especially in the emerging markets, because documenting their income in connection with a mortgage application can be difficult. Further, interested borrowers should be given the option of choosing a stated income loan versus a fully documented income loan if the borrower so chooses and if the lender has disclosed any cost difference.
- Home Improvement Contracts. Lenders should disburse loan proceeds to the borrower or jointly to the borrower and the contractor, or through a third-party escrow agent. Lenders must not disburse loan proceeds until the payment is approved in writing by the borrower, the contractor has signed a certificate of completion or the contract, and the property has been made available to the lender for inspection.

D. Standards for All Loans:

- Right to Cure. A national standard should permit lenders reasonable time to "cure" any unintended errors in the mortgage transaction without incurring any further or punitive liability.
- Accurate Appraisals. When formal valuation methods are required, lenders must evaluate properties through real estate appraisal professionals and/or through automated valuation models. Participants to the transaction must be careful not to either pressure or be pressured. Lenders must ensure that the appraiser is licensed as required by law and make a good faith effort to ensure the appraiser is in good standing.

Finally, while any increases in delinquencies and foreclosures are an important concern, prohibition of particular products is not a solution – because they are not the cause. Many borrowers have used a range of products effectively to realize their dream of homeownership and otherwise satisfy the financial demands that we all face.

Conclusion

MBA members have worked hard to put Americans in homes, facilitating the development of communities, increasing consumer wealth and improving the stability of families across the nation. The transitioning of the subprime mortgage market and the affect it is having and, will likely continue to have on access to mortgage credit is a challenge for us all. MBA implores Congress not to act hastily but to partner with industry and consumer groups to develop new approaches to help borrowers get the mortgage credit to fulfill their dreams of homeownership or to refinance into a new loan.

MBA has been long committed to fighting predatory lending and we would welcome the opportunity to work with Congress to develop policies that weed out bad actors and allow the mortgage industry to continue to serve borrowers. Financial literacy, mortgage simplification and a uniform national standard are steps Congress can take to address abusive lending.

MBA wants to underscore the importance of innovation in making credit opportunities available to consumers. MBA believes that borrower choice should be protected. The imposition of a suitability standard risks undermining our hard won gains in the areas of homeownership and reaching underserved borrowers. It will take away consumer choice as well as access to affordable mortgage credit.

Lenders and consumers alike have every incentive to keep borrowers in homes. Foreclosure is a loss for everyone. Foreclosures are caused in large measure by life events like job loss, divorce and illness. Lenders work very hard to offset foreclosure and work with delinquent borrowers to try to keep them in their homes.

MBA looks forward to continuing to work with this subommittee and the whole Congress to address challenges in the housing market and we stand ready to assist you however we can.

Thank you.

Prepared Testimony of

Harry H. Dinham, CMC, NAMB President

National Association of Mortgage Brokers

on

"Subprime and Predatory Lending:

New Regulatory Guidance, Current Market Conditions,

and Effects on Regulated Financial Institutions"

Before the

Subcommittee on Financial Institutions and Consumer Credit

Committee on Financial Services

United States House of Representatives

Tuesday, March 27, 2007

Good morning Chairwoman Maloney, Ranking Member Gillmor, and Members of the Subcommittee, I am Harry Dinham, CMC, President of the National Association of Mortgage Brokers ("NAMB"). Thank you for inviting NAMB to testify today on subprime lending, proposed regulatory guidance, and the state of the current housing market. We appreciate the opportunity to address the need to combat predatory lending practices while maintaining a competitive and strong housing market.

NAMB is the only trade association exclusively devoted to representing the mortgage broker industry and speaks on behalf of more than 25,000 members in 50 states and the District of Columbia. Our members are independent, small business men and women that adhere to a strict code of ethics and best lending practices when taking consumers through the loan process. We

typically maintain business relationships with various lenders to provide consumers with numerous financing options. These partnerships allow our members to offer consumers the most competitive mortgage products available.

We commend this Subcommittee for holding this important hearing to address the challenges facing the subprime market, such as the increasing rate of mortgage delinquencies and foreclosures, and examine the efficacy of current proposals. We appreciate the salient concerns raised by the need to balance measures designed to curb predatory lending practices against the need to preserve fair and affordable access to credit.

It is a tragedy for any consumer to lose their home to foreclosure. At the same time, America enjoys an all-time record rate of homeownership. The challenge before us is to find a solution to the tragedy of foreclosure while at the same time ensuring that consumers continue to have access to the credit they need to finance their homes.

I. Record Homeownership

In 2002, the President called upon the real estate and mortgage-finance industries to help accomplish "America's Homeownership Challenge" ("Challenge"). This Challenge called on the industry to take "concrete steps to tear down the barriers to homeownership that face minority families."[1] The President set a goal of increasing the number of minority homeowners by 5.5 million families by 2010.

Shortly after the President's Challenge was released, the Department of Housing and Urban Development ("HUD") released a report that identified the most significant barriers to minority homeownership (the "Report").[2] The five major obstacles listed were:

1. lack of capital for the down payment and closing costs;
2. lack of access to credit and poor credit history;
3. lack of understanding and information about the home buying process, especially for families for whom English is a second language;
4. regulatory burdens imposed on the production of housing; and
5. continued housing discrimination.

The Report stated that, combined, these factors "produced a gap in which non-Hispanic whites enjoyed a 68% homeownership rate, compared to only 48% for African-Americans and 47.6% for Hispanics." Echoing the President's Challenge, HUD also called upon the real estate and mortgage lending industries to "increase their levels of product innovation and marketing to minority families in order to sustain" growth rates achieved in the 1990s.

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[1] "A Home of Your Own: Expanding Opportunities For All Americans." George W. Bush (June 2002). http://www.whitehouse.gov/infocus/homeownership/homeownership-policy-book-whole.pdf.
[2] "Barriers to Minority Homeownership." U.S. Department of Housing and Urban Development (June 2002). http://www.hud.gov/news/releasedocs/barriers.cfm.

The industry responded. To achieve the goals set by the Administration and reaffirmed by HUD, mortgage originators, realtors, lenders, underwriters, and the securitizers and investors of Wall Street worked together to develop and deliver innovative loan financing options. The task presented was a difficult one given that over the years affordable housing had become sparse, especially in major metropolitan and coastal cities. High home prices, along with a lack of affordable financing options from the government sponsored enterprises ("GSEs") and the Federal Housing Administration ("FHA"), led to the inability of many first-time, low-income and minority homebuyers with imperfect credit history to enter into the housing market in these cities. But the secondary market, along with pioneering banks and lenders, filled the void with liquidity and an expanding range of loan options designed to meet the need for these consumers to find affordable financing options so they could obtain and maintain homeownership.

This allowed more Americans to achieve the goal of homeownership and brought about record rates of homeownership that have reached nearly 70%. New products are credited with addressing exactly the concerns identified in HUD's Report – providing financial options to families with little or no credit access, minimal, if any, down payment, lower monthly payments, and less "cash-out-of-pocket" at closing.

Achieving a homeownership rate of almost 70% and enabling more minority families to enjoy the multitude of benefits offered by homeownership – from community investment to wealth-building ability – is an impressive accomplishment for which the entire mortgage industry, along with this government, deserves credit. The zeal to achieve the benchmarks and objectives laid out by the current Administration has resulted in circumstances that now present industry and the government with a set of new concerns and challenges.

II. The Mechanics of Today's Mortgage Market

Today, the majority of subprime loan transactions begin with a mortgage originator (usually a mortgage lender, bank, credit union or mortgage broker) that has direct contact with the consumer. The mortgage originator is responsible for explaining the loan products he or she has to offer to the consumer; providing answers to the consumer's questions; and gathering the consumer's financing information for the loan application. The originator then submits this loan application to one or more lenders, who have the capacity to fund the loan, for approval or disapproval. At this point, the lender is responsible for underwriting the loan by reviewing the information submitted in the loan application, the applicant's credit report, and an appraisal on the property, in addition to other information.

The next step involves the lender making the decision on whether to fund the loan based on the applicant's credit history, income, assets and liabilities and property value. The underwriter must decide whether the applicant falls within pre-set risk parameters of the underwriting guidelines. Much of this process is now automated and is based on copyrighted and patented formulae. This automated review generally takes into account certain loan characteristics (income documentation type, prepayment penalty and loan to value) and applicant characteristics (credit score) to generate a "yes" or a "no" on the loan application. If the process yields an approval, the interest rate offered on the loan reflects the overall risk of the loan transaction as

determined by this automated underwriting review and type of product requested. It is rare for a mortgage broker to underwrite a loan they originate.

Once the lender decides to fund and close the loan, the originator is notified that the loan is approved and therefore, moves forward with the closing. The lender can either hold this loan in its portfolio and service it, or sell the loan. It used to be, some 10 or 15 years ago, that the majority of lenders retained and serviced these loans. This was largely because there was no effective mechanism available for lenders to systematically remove the loans from their books and "free-up" their capital. But, the emergence and rapid development of the mortgage securitization market changed the way most lenders now conduct business.

Today, the bulk of these loans can be sold almost instantaneously to an investment bank and securitized for investment. Specifically, an investment bank purchases these loans from multiple lenders, bundles them into a pool, creates a security and then sells the securities to various investors. These investors are large institutional investors, hedge funds, pension funds and other fixed-income investors. The investment bank typically also sells the valuable servicing rights to a servicer, who then retains the right to service the pooled loans and collects a servicing fee.

Because the majority of these non-depository lenders rely on lines of credit to finance closed loans, they tend not to tie up their capital in existing loans and restrict origination volume. Thus, these lenders typically sell their loans as quickly as possible to the secondary market to avoid interest costs associated with carrying the loan as well as interest rate risk. Most residential mortgage loans – some say up to 85% – are quickly sold to Wall Street investors to avoid the risks associated with holding the loans.

As a result, much of the current mortgage market is driven ultimately by Wall Street investors and the credit agencies charged with rating the risks associated with these pools of loans. These market players establish the risk tolerances acceptable for the pooled loans. This, in turn, informs the design of loan products and borrower risk profiles deemed acceptable by the lenders' underwriting criteria. In the end, Wall Street creates a demand for particular mortgages; underwriting criteria for these mortgages is set to meet this demand and this underwriting criteria, not the mortgage originator, dictates whether a consumer qualifies for a particular loan product. Certainly the set of challenges and concerns we face today are the result of a number of factors, including inadequate pricing models, imprudent product design, and poor management of risk.

III. Today's Reality: Rising Delinquencies and Foreclosures

Today consumers, industry, and government are challenged by the rising number of mortgage delinquencies. Consumers are faced with the prospect of losing their homes. No one questions the tragedy of this fact. Even one family losing their home to foreclosure is one too many, regardless of the cause. For this reason, NAMB is committed to working with this Subcommittee and others to ensure that homeowners not only have continued access to affordable credit but also are able to preserve their dream of homeownership.

But the unanswered question is: what is causing the rise in mortgage delinquencies and home foreclosures? No one knows for sure, but we believe there may be a number of factors:

- New homeowners unprepared for the costs and responsibilities of homeownership;
- Bankruptcy Reform;
- Speculative bubble in real estate values;
- Refinancing to cure delinquencies;
- Minimal wage gains;
- Illness and other life events;
- Credit card debt;
- Decreased savings rate;
- Fluctuating home values;
- Mortgage Fraud;
- Consumer Fraud;[3]
- Appraiser Fraud;
- Title Insurance Fraud;
- Predatory Practices;
- Risk layering;
- Consumers desire to live above and beyond their means;
- Cash-out refinancing to maintain unsustainable standard of living;
- Consumer financial literacy;
- Owner v. non-owner occupied;
- Buyers of property with an intent to resell quickly;
- Criminal Enterprises;
- Bad Acts and Bad Actors;
- Investors and Speculators;
- Shrinking middle class;
- Exporting of jobs;
- New replacement jobs at low wages;
- The role of the secondary market; and
- Regional job loss.

The chances are unlikely that there is one cause of foreclosures.

IV. No Rush to Judgment

Before we rush to judgment and conclude that a particular segment of the mortgage market or practice is largely responsible for the increase in home foreclosures, it is imperative to at least examine and verify the true causal factors for the increase in mortgage delinquencies and home foreclosures. We should not jeopardize the vast majority of consumers who have succeeded in using many innovative loan options to attain and maintain their homes. Do not forget those

[3] *See* Merle Sharick, Erin E. Omba, Nick Larson, D. James Croft of Mortgage Asset Research Institute, Inc., Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association ,p. 12 (April 2006) http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf.

consumers who have benefited in the past, and could still benefit in the future, from these loan options and expanded access to credit.

Today, we can only speculate as to the reasons for the increase in mortgage delinquencies and home foreclosures. As a result, we can only make assumptions and take what is tantamount to a trial-and-error approach to possible resolutions. We have no assurances that certain policy proposals are either appropriate or will yield desired results. NAMB does not believe that consumers should continue to suffer as we take a 'trial and error' approach—it is unfair and can result in unintended consequences.[4]

NAMB believes the problem of rising foreclosures is complex and will not be corrected by simply removing products from the market. As a study by the Office of the Comptroller of the Currency in 2006 states, "the relationship between predatory lending practices and foreclosure rates is more complicated than the arguments for restricting their (nontraditional loan products) use suggest. Policies that encourage subprime lenders to review and tighten loan underwriting and pricing procedures to ensure borrowers' abilities to repay their loans are fully reflected in lending decisions and terms may be more effective than prohibitions on specific lending practices."[5]

Instead, NAMB believes government and industry should take a step back and evaluate all the factors that could play a role in determining whether a family is forced to foreclose on their home.

V. The Need for an Independent Study

NAMB firmly believes that an independent study to identify and examine the causes of foreclosures is necessary before we can create well-designed and effective solutions. Although numerous foreclosure studies exist, they are not independent and tend to focus solely on *a* single causal factor. To understand the true causal effects of foreclosures, NAMB urges Congress to request the General Accounting Office ("GAO") to conduct a study that is sufficiently broad to encompass all of the above-mentioned factors and is performed over an adequate period of time to take into account seasonal and cyclical changes in the market.

A long-term, independent study will aid the industry and government in determining the appropriate steps for long-term solutions to the foreclosure problem while ensuring that consumer choice, product innovation and the ability to maintain record rates of homeownership are not negatively impacted. In addition, NAMB believes that to pursue a comprehensive approach to the issues raised by the increase in foreclosure rates, we must include not only originators in the discussion, but also those who fund, service and collect on mortgage loans.

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[4] *See* Mary Umberger, *Home buyer Counseling Challenged*, Chicago Tribune, Nov. 2, 2006. *See. https://www.hb4050info.com/Public_Web/Home.aspx* for more information on the Cook County Illinois Predatory Lending Database, mandated by Article 3 of the Residential Real Property Disclosure Act1, ("H.B. 4050") that led to falling neighborhood values, discrimination lawsuits, and lenders pulling out of the area. The program was suspended on January 27, 2006. *See https://www.hb4050info.com/pdfs/4050Scan001.pdf.*

[5] Morgan J. Rose "Foreclosures of Subprime Mortgages in Chicago: Analyzing the Role of Predatory Lending Practices." (August 2006).

Origination is but one step in the process of how a consumer secures financing to achieve and maintain homeownership.

However, as we all acknowledge and confront these problems and in our zeal to protect consumers from or help them weather the causes of foreclosures, whatever they may be, NAMB urges consumer advocacy groups, industry and the government not to forget the original goal to increase homeownership and the success that has been achieved by creating new products. Today, more Americans own their home than ever before and while we must work to ensure Americans are able to stay in their homes, we must also be cognizant of the unintended consequences that overly prescriptive policies can have on families who have not yet achieved homeownership.

VI. Policy Recommendations

Although we believe that this independent study must be performed, we appreciate that it is a long-term project that will not provide immediate relief to those consumers suffering from or facing the prospect of home foreclosure. We must also develop short-term solutions.

As discussed previously, the industry responded to this Administration's Challenge to increase homeownership. In the past five years alone we have witnessed a proliferation of market players and the development of numerous innovative loan products. Together, these developments have resulted in a healthy and competitive market that offers increased access to affordable credit.

But during this same time period, there were missed opportunities to address the growing need for a simplified mortgage process; prevent payment shock; and ensure that all loan originators were able to communicate the risks and benefits of increasingly complex loan products.

Now is the time to act. NAMB supports adoption of the proposed interagency statement on subprime lending ("Proposed Statement")[6] so long as the key principles reflect a balanced approach to the market that seeks to protect and inform consumers while avoiding a market over-reaction and exacerbation of the current subprime credit crunch. NAMB also takes this opportunity to emphasize once more the need to (i) make FHA loan products a real and viable alternative to the subprime market; (ii) move forward with meaningful and effective Real Estate Settlement Procedures Act of 1974 ("RESPA") Reform; (iii) create uniform, minimum education standards for all loan originators, and ensure any proposed licensing schematic is an improvement on current requirements and not simply an extension of a system riddled with exemptions; and (iv) commit funding towards enforcement and consumer financial literacy efforts. In addition, NAMB proposes the creation and use of a loan-specific disclosure to communicate key loan features upfront and deter the prospect of payment shock.

Before we address each of these policy proposals, we want to emphasize that regardless of what measures we pursue, we should ensure that the integrity of the consumer decision-making process remains intact, and that we do not risk 'turning back the clock' to a pre-Fair Housing Act era where certain population segments were unfairly denied access to loan financing options.

[6] Proposed Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10533 (Mar. 8, 2007).

Protecting the Consumer's Right to Remain the Decision-Maker

The consumer is the ultimate decision maker on the product, the price and the services purchased in conjunction with obtaining their financing. No merchant, no government and no company should superimpose their own moral judgments on what is a basic American privilege of homeownership. NAMB remains opposed to any proposed law, regulation or other measure that attempts to impose a fiduciary duty, in any fashion, upon a mortgage broker or any other originator.[7]

Simply put, a mortgage broker should not, and cannot, owe a fiduciary duty to a borrower. The consumer is the decision maker, *not the mortgage broker*. Mortgage brokers do not represent every loan product available in the marketplace, nor do we have the "best" loan available. Rather, the mortgage broker enters into contracts with various lenders and is then able to offer such lenders' loan products directly to the consumer. This is a critical point because there is no "best" result. What is "best" depends upon three inter-related concepts: product availability, price, and service. Focusing solely on a price of a product may not yield the "best" result for a consumer. Only the consumer can determine the "best" combination of factors that fit their needs.

Some have suggested that mortgage originators (not exclusively mortgage brokers) be subject to a suitability standard when dealing with consumers. This concept has not been thoroughly defined in the mortgage context. An ill-defined and vaguely worded suitability standard will do nothing more than inject greater subjectivity and vagueness into a process that today should be incorporating mostly, if not only, objective factors. Moreover, such a standard will create uncertainty and confusion in the marketplace, spurring litigation, which in turn will increase the cost of credit.

Some have suggested that mortgage brokers are not regulated. We disagree and we have submitted for the record a memorandum that highlights the federal and state laws that govern our industry.[8] It is difficult to harmonize the assertion that the mortgage originator industry suffers from inadequate oversight and enforcement with a proposal that will require these very same originators to make highly discretionary and subjective judgments.

For these reasons, we do not support any law or regulation that requires any mortgage originator to supplant the consumer's ability to decide for him or herself what is or is not the "best "loan product. As the decision-maker, the role of the consumer is to acquire the financial acumen necessary and take advantage of the competitive market place, shop, compare, ask questions and expect answers.

NAMB believes that the government, consumer advocates, and mortgage originators and others should work together to develop and implement appropriate solutions. NAMB believes the below outlined policy recommendations represents a good-faith step in this direction and we look forward to continuing dialogue with this Subcommittee to develop workable solutions.

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[7] *See* Attached Appendix A, *The Relationship of the Mortgage Broker to Its Consumer.*
[8] *See* Attached Appendix B, *The Regulation & Oversight of the Mortgage Broker Industry.*

A. Adopt Balanced Guidance on Subprime Lending

On March 8th, the regulatory agencies of the Federal Financial Institutions Examinations Council ("FFIEC")[9] jointly issued the Proposed Statement addressing lending practices within the subprime market. NAMB is currently reviewing the Proposed Statement and intends to submit detailed comments on all aspects by the current comment due date of May 7, 2007.

However, we take this opportunity to express our general support for the intent behind the key principles outlined within the Proposed Statement, and the need to ensure that it is applied uniformly and equally, in the same fashion, to both federal and state-regulated entities.

In particular, NAMB supports measures outlined in the Proposed Statement that seek to limit payment shock through clear and straightforward mortgage descriptions and advertisements. In fact, NAMB has proposed a loan-specific disclosure (discussed more fully below) that would disclose to the consumer payment and interest rate variations, as well as pertinent loan features such as negative amortization and prepayment penalties

However, NAMB cautions against proposed measures that could result in purposeful elimination of viable loan products that have served in the past, and continue to serve today, a real customer need. Subprime lending has allowed many consumers, who were previously shut out from the mortgage market, access to credit and homeownership for the first time. The subprime market has allowed consumers with blemished credit histories the opportunity of homeownership while giving them the time to repair their credit and become eligible for prime loans. For borrowers residing in high-cost areas, the subprime market was often the only means available to obtain homeownership because of a lack of presence from the GSEs (*i.e.*, Freddie Mac and Fannie Mae) due to the burdensome loan limitations and FHA. Many of these consumers are living comfortably in their homes and are not facing foreclosure. The bottom line is that unwarranted tightening of underwriting guidelines could deny deserving consumers the chance at homeownership.

In the fall of 2006, NAMB also took the opportunity to submit comments and recommendations to the Federal Banking Agencies, as well as the Conference of State Bank Supervisors ("CSBS") and the American Association of Residential Mortgage Regulators ("AARMR"), on the Interagency Guidance on Nontraditional Mortgage Products released in December 2005 ("Nontraditional Guidance").[10] In our letter, we expressed support for those elements in the Nontraditional Guidance that address consumer knowledge of nontraditional mortgage products and similarly cautioned against efforts that would eliminate viable loan products or unduly restrict innovation.

Most importantly, we expressed our support for the expansion of the Nontraditional Guidance to all market participants through the companion guidance issued by CSBS and AARMR

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[9] The FFIEC includes the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDCI), the Office of Thrift Supervision (OTS), the Office of the comptroller of the Currency (OCC), and the National Credit Union Administration (NCUA) (together, the "Federal Banking Agencies").

[10] Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77249 (Dec. 29, 2005).

("Companion Guidance").[11] In fact, on November 5, 2006, NAMB voted unanimously to supports states' adoption of the Companion Guidance *provided* that it was (1) adopted by states in a form and substance that mirrors the principles outlined in the Federal Guidance, (2) applicable to all mortgage originators, and (3) implemented with the same force and effect as the Federal Guidance, *i.e.*, as guidance or best practices, not as law or regulation.

In our continued effort to promote consistency, uniform application, and a level playing field, we similarly express our support for expanding the Proposed Statement, once finalized, to all market participants, whether federally or state-regulated, so long as the principles are applied equally and in the same fashion to all mortgage originators. NAMB believes that uneven or uncoordinated implementation of the Proposed Statement will create consumer confusion and marketplace inefficiencies.

We look forward to working with the Federal Banking Agencies, CSBS and AARMR to address the safety and soundness issues presented by the subprime market and to implement policy decisions that will aid in consumer education and knowledge about the risks and benefits posed by subprime lending practices.

B. Make FHA a Real Choice for Subprime Borrowers

A stated objective of the FHA is to increase origination of FHA loan products and expand homeownership opportunities for first-time, minority and low to moderate-income families. NAMB supports increased access to FHA loans so that prospective borrowers who have blemished credit histories, or who can afford only minimal down payments, have increased choice of affordable loan products. These prospective borrowers should not be forced by default into the subprime market. A recent *Inside Mortgage Finance* publication estimated the current FHA market share at 2.7%.[12] NAMB believes the solution to increasing FHA loan origination and market share is increasing the number of origination sources responsible for delivering FHA loan products directly to consumers. Today, the most effective and efficient origination source is through mortgage brokers, the vast majority of which are small business men and women.

Mortgage brokers originate over 50% of all home loans, yet brokers are responsible for just 10% of FHA's origination volume, or .27% of all FHA home loans. This is due, in large part, to the fact that mortgage brokers are discouraged from participating in the FHA program by the unnecessarily burdensome financial audit and net worth requirements. These requirements erect a formidable barrier and prevent a significant majority of mortgage brokers from participating in the program.

NAMB estimates that less than 18% of all mortgage brokers are approved to originate FHA loans under the current requirements; however, recent NAMB surveys indicate that roughly 80% of "non-participating" mortgage brokers would offer FHA loans to their customers if there were no financial barriers. NAMB predicts that such a change would increase mortgage broker participation in the FHA program from 18% to roughly 85%. This, in turn, would increase FHA's loan origination volume and market share by nearly 40%.

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[11] CSBS and AARMR subsequently issued guidance that mirrored the Nontraditional Guidance on November 14, 2007.

[12] *See* Inside Mortgage Finance, Mortgage Originations by Product, p.7 (March 2, 2007).

For example, in 2006, FHA's origination volume was roughly $80 billion.[13] All things being equal, the 67% increase in broker participation would increase FHA's origination volume to nearly $112 billion, and FHA's total market share from 2.7% to 3.78%. This increase of $32 billion and 1.08% total market share will be directly tied to an increase in mortgage broker participation in the FHA program.

There are some that continue to argue that increasing broker access to the FHA program will place the FHA program at risk. Respectfully, these claims have no basis. First, today mortgage brokers are able to originate loans for the Veterans Administration ("VA") loan program without the significant hurdles of net worth and audit requirements. Mortgage brokers submit a flat certification fee and, operating through a large lender, are able to originate VA loans. The VA loan program has a minimal default rate.

Second, it is simply untrue that brokers will not be subject to appropriate oversight and supervision if a bond replaces the audit and net worth requirement. Today, mortgage brokers participate in the FHA program typically through a large lender. Replacing net worth and audit requirements with a surety bond will not change the framework set to ensure responsibility and accountability, it will simply encourage brokers to participate thereby increasing the amount of FHA loans offered. The larger FHA-approved lenders will continue to submit to the standards deemed necessary by FHA (i.e. audits, net worth etc.) before being approved to offer FHA loans through retail or wholesale channels. This affords HUD adequate protection against loss to the FHA program. Brokers who choose to offer FHA loan products will also continue to be governed by contract agreements with these respective FHA-approved lenders. Additionally, brokers who participate in the FHA-program will remain state-licensed entities subject to any state bond requirements, criminal background checks and education requirements *in addition* to any FHA-required surety bond. This, in effect, creates a dual-layer of protection for both the FHA program and the consumer. Last, the process of obtaining a surety bond itself involves stringent standards and review. Surety companies pre-qualify their customers to determine whether they are financially sound and have the baseline to conduct their business, *i.e.* ability to pay out upon a loss, before issuing a surety bond.

C. Modernize Out-Dated Disclosures

NAMB supports clear, consistent, and uniform communication with the consumer from the shopping stage through consummation and afterwards throughout the life of the loan (*i.e.*, monthly statements). Disclosures – when designed and used appropriately in conjunction with originator and consumer financial literacy efforts – alert potential borrowers to the risks and benefits presented by any particular loan product and support meaningful comparison shopping. Disclosures aid the consumer in exercising their right to make an informed choice.

NAMB reiterates the need to revise existing mortgage disclosures that are out-dated and reflect a mortgage system of 20+ years ago. We encourage HUD and the Federal Reserve Board (the "Board") to review and update key disclosures given to consumers during the home buying process, such as the Good Faith Estimate ("GFE") and the Truth In Lending ("TIL") statement.

[13] *See* Inside Mortgage Finance, Mortgage Originations by Product, p.7 (March 2, 2007).

These disclosures are critical to the home buying process and should be modernized to reflect the growing popularity of varied mortgage products in the mortgage market.

NAMB also strongly recommends consumer testing of any revised, or newly proposed, disclosure to better glean the utility and effectiveness of the disclosure format. As stated by Julie L. Williams, Former Acting Comptroller of the Currency, "There's a critical element that's been missing from our consumer disclosure rulemaking processes—testing *how consumers interpret* particular disclosures and how to make disclosures *usable* to them."[14] Only consumer input can shed light on whether the information provided is too dense, too complex, insufficient or in need of further explanation. Consumer testing can also provide insight to our current disclosure regime and how technology can be used to improve the disclosure process.

1. GFE Reform

In 2005, NAMB proposed a one-page GFE[15] in response to a series of roundtables conducted jointly by the HUD and the Small Business Administration throughout the summer of 2005. This one-page GFE mirrors the HUD-1 consumers receive at settlement and communicates not only the loan features and costs, but fully discloses the role of the loan originator in the mortgage transaction. Most important, the revised GFE would provide the information most valued by the consumer—meaningful closing costs and monthly payment.

The one-page GFE is a viable solution to the problem of abusive lending because it applies equally to all segments of the mortgage industry; is effective in preventing abusive lending tactics, such as bait-and-switch schemes; is informative because it clearly and objectively informs the borrower of the role of the loan originator in the transaction; and is enforceable, because it grants the consumer a private right of action.

Specifically, the NAMB proposed GFE possesses four distinct attributes:

First, it is even-handed. The NAMB proposed GFE would be equally applicable to all originators conducting business in the mortgage marketplace. Of import, the proposed NAMB GFE treats the disclosure of rate, fees, costs and points uniformly regardless of distribution channel, giving meaning to the ability to "comparison shop." As a result, distribution channel bias is eliminated and all consumers are afforded the same level of protection against abusive lending tactics.

Second, it is informative. The NAMB proposed GFE clearly discloses the role of the originator in the mortgage transaction. The borrower is notified that the loan originator does not distribute all of the loans available in the marketplace and therefore, can not guarantee the lowest rate. This aspect of the proposed GFE is significant. For example, as discussed previously, a loan product offering the lowest interest rate may not necessarily be the "best" loan product for the borrower. It is far more effective to disclose the role of the broker, the loan features and costs, and empower the consumer to comparison shop and choose a product that suits his or her needs.

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[14] *See* Remarks by Julie L. Williams, Acting Comptroller of the Currency Before Women in Housing and Finance and The Exchequer Club, Washington D.C. (January 12, 2005).
[15] *See* Attached Appendix C, NAMB Proposed GFE.

Also, requiring that every mortgage originator disclose his or her role and relationship with the borrower will eliminate any confusion on the part of the borrower—this approach actually ensures that a borrower is not operating under a faulty impression that an originator, such as a bank-affiliated mortgage lender, owes him or her a fiduciary duty.

Third, it is effective. The NAMB proposed GFE is effective in combating abusive lending tactics because it provides simplicity, clarity and transparency of the loan costs and features. It is one-page in length; mirrors the HUD-1 settlement statement; requires mandatory re-disclosure if settlement costs increase by more than 10% of the original estimate, or if the proposed interest rate increases.

Fourth, it is enforceable. Consumers are given a private right of action to enforce the GFE tolerance limits of 10% if no timely re-disclosure is given to the consumer.

We believe the NAMB proposed GFE form will build consensus among stakeholder groups while achieving HUD's stated goals of simplicity, clarity, transparency, and greater cost certainty for consumers. However, it is now 2007 and HUD has yet to release a revised version of the GFE. NAMB urges HUD to move forward and work with the industry to develop and roll-out a GFE that incorporates the key elements outlined above and is more beneficial to consumers.

2. Loan Specific Payment Shock Disclosure

Current disclosures have failed to keep pace with market innovations, especially in the area of variable rate loans. Today, consumers are not given the tools needed to shop effectively for a mortgage in a market offering increasingly creative and complex options. Disclosures are laden with legalese, are inconsistent, are not required uniformly across all distribution channels, and fail to provide the information that consumers need most when making a decision. Most notably, there is no current loan specific disclosure that communicates to the borrower the variability of their monthly payment (*i.e.,* your monthly payment can go up to X) or interest rate (*i.e.,* your current interest rate is valid only for X months).[16] As a result, consumers are left confused, unable to comparison shop loan products, and subject to payment shock. There is a critical need for a uniform disclosure required across all distribution channels that will clearly and concisely impart loan specific information to the consumer and prevent unwanted surprises about payment shock and interest rate variations.

NAMB proposes a loan specific payment disclosure notice that will: (1) <u>educate</u> the consumer about the specific loan product being considered and/or chosen, and (2) <u>enable</u> consumers to exercise an informed and independent choice about a particular loan product. A mortgage originator knowledgeable about the various market products would be able to also assist the consumer in understanding the information provided on the loan specific disclosure – the risks, the benefits and the choices available.

[16] TILA does not adequately reflect the changing payment scheme and interest rate of many loan product types available on the market today. The recent CHARM booklet, as well as the new Interest Only & Pay-Option ARM booklet, provide excellent background information, but lack the specificity about a loan product's features that the consumer needs to know when deciding which loan product meets their needs.

To address the issues of payment and interest rate shock, we recommend:

1. Requiring all loan originators to provide consumers, regardless of loan-product type, with a loan-specific payment disclosure;
2. Disclosing the consumer payment variations, (*e.g.*, a minimum and maximum payment for every loan product), interest rate variations, and information about pertinent features such as prepayment penalty and negative amortization, if applicable;
3. Requiring this disclosure through regulation to speed its implementation. Specifically, the initial loan-specific disclosure provided early in the shopping stage can be required through RESPA (*e.g.*, can accompany the estimated GFE), and the final loan-specific disclosure can be required at closing through Truth In Lending Act ("TILA"); and
4. Consumer testing by an independent third-party or governmental agency prior to implementing and requiring that all originators provide this disclosure.

A uniform and straight-forward disclosure, such as the one proposed here, will aid in the comparison shopping process for consumers and will provide a more simplistic explanation of the "worst-case-scenario."

D. Improve Professional Standards for All Mortgage Originators

Before discussing the need to improve professional standards for all mortgage originators, we take this opportunity to address once more the repeated assertion that mortgage brokers are unregulated or lightly regulated. This statement is simply not true. Mortgage brokers comply with multiple federal and state laws and regulations governing the mortgage origination industry.[17] Mortgage brokers are licensed or registered, and comply with any required pre-licensure and continuing education requirements and criminal background checks, in 49 states and the District of Columbia, and actively support licensing of all mortgage originators in the last remaining state of Alaska. Not only are our entities licensed or registered, but in approximately half of these states our loan officers must also be licensed or registered. As small businessmen and women, mortgage brokers comply with numerous state predatory lending and consumer protection laws, regulations and ordinances (*i.e.*, UDAP laws). On the state level, mortgage brokers are subject to oversight, audit and/or investigation by their mortgage regulator, the attorney general, or their state agency, and in some instances all three.

Unfortunately, the growth we have witnessed in our mortgage finance industry has led to a corresponding rise in the number of uneducated and unlicensed mortgage originators. While states are increasing requirements for mortgage brokers and their employees, they continue to exempt the many loan officers of both depository and non-depository lenders from important education standards and critical filters, such as criminal background checks. Many states also

[17] Mortgage brokers are regulated by more than ten federal laws, are under the oversight of HUD and the FTC, and to a certain extent, the Board, the Internal Revenue Service, and the Department of Labor. In addition, small business mortgage brokers must also comply with a number of laws and regulations governing the conduct of business activity within the states. *See* Appendix B for a complete description of governing laws and regulations.

exempt lenders (including their loan officers) from licensing if they are HUD, FHA or Fannie-Mae approved. In fact, in some states, the mortgage lender entities themselves remain exempt from any licensing or registration construct at all.[18]

We make the above point because consumers are often unable to distinguish one origination source (*i.e.*, a mortgage broker, banker, lender, or even depository banker) from another. From the perspective of the consumer, there is little substantive difference between them. Over the past 10 to 15 years, the mortgage industry has evolved significantly with no clear delineation between distribution channels. This fact is significant because, as explained previously, it used to be that lenders and brokers were differentiated by the fact that lenders always retained loans in their portfolio and serviced them. With the advent of the mortgage securitization market, this is no longer true—almost 85% of originated loans are quickly sold to the secondary market. This means that approximately 85% of the mortgage origination market functions as a mortgage broker.

Today, a mortgage broker should include anyone that originates a loan with the intent or practice of delivering, distributing or selling it, servicing released, within 120 days. This current definition better reflects how the market operates. It captures not only mortgage brokers but the majority of mortgage lenders and their employed loan officers who lend with the expectation of almost immediate repayment from the secondary market. Yet, state and federal consumer protection and finance laws have failed to keep pace with these developments.

1. Require Education Standards and Criminal Background Checks for All Mortgage Originators

We believe more can and should be done to increase professional standards for all mortgage originators. NAMB is the only national trade group that has advocated for the past seven years to increase professional standards for all mortgage originators.

To this end, NAMB believes that part of the solution to successfully combat abusive lending tactics and reduce the number of foreclosures in America is to require education of all mortgage originators – not just mortgage brokers. Education of each and every mortgage originator helps to ensure that consumers are provided with sufficient information to make an informed decision about available loan financing options in the market.

To ensure all mortgage originators are well educated and knowledgeable about the loan products offered, NAMB has long advocated for education (including ethics training) and criminal background checks for each and every individual that handles a 1003 application,[19] *i.e.* every mortgage originator.[20] NAMB agrees that all "[l]ending personnel should be trained so that they

[18] According to a recent article in the *American Banker*, South Carolina is one of eight states that currently do not regulate mortgage bankers and lenders. The other seven states lacking mortgage banker or lender regulation are Alabama, Alaska, Colorado, Indiana, Montana, North Dakota and Ohio. *See* Luke Millens, Statehouse Report: South Carolina Seeking More Regulation in Mortgages, American Banker (March 20, 2007).

[19] A Form 1003 is a Uniform Residential Loan Application.

[20] The basic requirements of education, continuing education, ethics training, written exams, and criminal background checks can be found in NAMB's ongoing work and commitment on the Model State Statute Initiative (MSSI) that NAMB began in 2002, which is attached hereto as Appendix D.

are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner."[21]

NAMB is committed to ensuring that all originators are knowledgeable about the range of loan products available in the marketplace and understand the features, risks and benefits of the loan types that they offer. For this reason, we support federal efforts to implement a national minimum education standard for all mortgage originators.

2. No More Missed Opportunities

Second, NAMB believes that we should no longer tolerate bypassing any opportunity to create a construct that truly offers all consumers protection, regardless of which distribution channel they use to obtain a loan. Unfortunately, a current proposal by CSBS and AARMR does just that. We are genuinely troubled by the continued representation (or misrepresentation) of CSBS and AARMR that their proposed construct is one that will effectively address some of the issues that have been the focal point of at least three Congressional hearings.

CSBS, an organization representing state bank regulators, and AARMR, an organization representing state residential mortgage regulators, have proposed a residential mortgage licensing and registry system ("Proposed System") that is riddled with gaps.[22] The stated principles of this Proposed System are allegedly to "improve the . . . effectiveness of state supervision of the U.S. mortgage market; . . . fight mortgage fraud and predatory lending; . . . increase accountability among mortgage industry professionals; and . . . streamline state [licensing] and standards for mortgage lenders and mortgage brokers."[23] However, the Proposed System, as currently designed and presented, falls short of achieving any of these objectives because it largely includes only one mortgage origination channel—the mortgage brokers—and excludes many others.

The Proposed System is built upon the current state licensing and registration scheme in place today, which, as discussed previously, exempts almost all the loan officers that work for mortgage lenders and bankers. This means that the Proposed System will also exempt the thousands of mortgage originators employed by these entities. In fact, mortgage lenders and bankers that operate in those states that have no state regulatory scheme will not be part of the Proposed System *at all*.

Why is this a serious problem? First, bad actors will continue to operate in the mortgage market unchecked. Under the Proposed System, loan officers employed by mortgage lenders or banks and found guilty of unethical practices, such as fraud, would not be tracked as they migrated freely from one lender's office to another, or from state to state. For example, South Carolina was recently identified as a national "hot spot" for mortgage fraud. That state does not currently

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[21] *See* Nontraditional Guidance, p. 35.

[22] CSBS and AARMR have proposed a residential mortgage licensing and registry system, to be operated and governed by a limited-liability company known as the State Regulatory Registry LLC (SRR).

[23] *See* CSBS and AARMR Statement of Intent, released February 27, 2007, at http://www.csbs.org/AM/Template.cfm?Section=Press_Releases&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=10147.

have *any* licensing or regulation over mortgage bankers and lenders,[24] allowing them to conduct business without a license and without submitting to a criminal background check. The Proposed System would not change this and therefore, would have minimal impact on the level of fraud in South Carolina.[25]

Second, both consumers and government agencies will be given a false sense of security. The exemption of over 60 percent of mortgage originators from the Proposed System leaves significant segments of the industry out of the process. As discussed above, consumers do not distinguish between origination channels. Both consumers and government agencies could be led to believe that the Proposed System is uniform and applicable to everyone that has contact with the borrower when in reality that perception is false. This false perception causes confusion and raises serious public policy concerns because the largest and most recent settlements and fines for predatory lending practices have involved lenders and banks (*i.e.,* Carteret Mortgage's settlement this year for 1.2 million in West Virginia alone; Ameriquest's $325 million dollar settlement in 2006; and Household and Beneficial Finance's $484 million dollar settlement in 2003).

We hope that CSBS and AARMR will take a leadership position and aid both Congress and the industry in curbing predatory lending practices and mortgage fraud in a manner that will actually offer real protection to consumers, rather than just the illusion of protection. We hope, with the support of this Subcommittee, that we can engage in a productive dialogue and work with CSBS and AARMR regarding the creation of improved professional standards for all mortgage originators.

E. Financial Literacy and the Borrower

NAMB believes consumers should possess the necessary financial knowledge to carefully evaluate the risks and rewards of traditional and nontraditional products. Financial literacy is the tool that consumers need to make an informed decision as to whether a particular product—traditional or nontraditional—meets their needs. Financial literacy is also a valuable tool that will help consumers avoid foreclosure. If a consumer understands the risks and rewards of the product they have chosen, they will have a better understanding of how to stay in their home and avoid foreclosure.

Regardless of how knowledgeable a mortgage originator is or becomes, an educated consumer is always in a better position to make an informed decision when selecting a loan product that can match his or her financial needs. Borrowers must possess the financial literacy tools to properly evaluate the risks and benefits of nontraditional mortgage products that have been highlighted and communicated by the educated mortgage originator. For this reason, NAMB urges Congress to allocate funds for financial literacy programs at the middle and high school level so that consumers are educated about the financial decisions they make and retain their decision-making ability.

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[24] In South Carolina, mortgage brokers are licensed to conduct business and must submit to criminal background checks.

[25] *See* Luke Millens, Statehouse Report: South Carolina Seeking More Regulation in Mortgages, American Banker (March 20, 2007).

NAMB has always been a staunch supporter and advocate for consumer financial literacy. Our firm belief that an educated borrower is significantly less likely to fall victim to any abusive lending practice and to avoid foreclosure is demonstrated by our active involvement in various consumer education efforts. For example, NAMB initiated a pilot consumer credit education program using Freddie Mac's CreditSmart® and CreditSmart® Español financial literacy curricula. The pilot is currently being managed by NAMB state affiliates in California, Florida and Texas. NAMB partnered with United Guaranty in 2003 to create a consumer information presentation – "Are You Prepared to Head Down the Road to Homeownership?®" – to help educate minorities, immigrants and low-to-moderate income households on the home-buying process. The presentation covers common home mortgage terminology, important steps in the home-buying process, fair housing laws, credit reports and more.

We recommend Congress to put forth measures and explore those avenues that outreach to borrowers and provide meaningful education to them in a timely fashion rather than just at the time of application or at the closing table. Possessing a fundamental understanding of the mortgage lending marketplace and the loan product types available will empower borrowers to comparison shop, ask meaningful questions and make financial decisions that advance their personal life objectives. Again, NAMB strongly believes that because financial education is the key to choosing the right loan product and protecting oneself against fraud, the consumer education process should begin at a young age. To this end, NAMB supports any effort that calls for federal funding to support consumer financial literacy efforts and outreach programs during the school years.

Again, thank you for the opportunity to appear before this Subcommittee today to discuss this timely issue. I am happy to answer any questions that you may have.

Appendix A

The Relationship of the Mortgage Broker to its Customer

The majority of mortgage brokers are small, independent businesses operating retail offices open to the public for the purpose of obtaining mortgage financing. Like any retail source, the mortgage broker has wholesale distribution channels which supply them with inventory, in this case, a variety of mortgage products. The mortgage broker provides rate and price flexibility and among other things, offers numerous loan products, collects information from the borrower, communicates such with the lenders and facilitates closings. The public, in turn is able to choose the product offered by that particular mortgage brokerage firm. If the shopper does not find the product or price they want, they go to another mortgage source.

It has been suggested that we should be the fiduciary agent for the borrowing consumer. The mortgage broker is **not** the exclusive agent for the lender **or** the borrower. The mortgage broker is an independent entity that typically has contractual loan origination arrangements with multiple wholesale lenders. As an independent entity, mortgage brokers rely on referral business, which is obtained by offering a combination of good customer service, a variety of mortgage products and competitive interest rates. A broker that does not offer all of the afore-mentioned, will most often not get the business, since customers have the ability to shop for the rate, product and service that they prefer. Since not all mortgage brokers offer the same loan products or are approved with all lending sources, it would be impossible to assure the "best" mortgage options to every customer, thus making fiduciary responsibility unattainable.

A member of the National Association of Mortgage Brokers adheres to a strict code of ethics and best lending practices which can be found at www.namb.org. Mortgage brokers do the majority of all the mortgage loans in this Country and the public has declared us their mortgage originator of choice. For the past several years the borrowing public has opted to use the mortgage broker as their lending source, primarily because of competitive pricing, varied mortgage products, professional service and convenient location and hours.

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Appendix B

THE REGULATION & OVERSIGHT OF THE MORTGAGE BROKER INDUSTRY

Background Information

There are a variety of distribution channels in the mortgage industry today, and each of these distribution channels is heavily regulated at both the state and federal level. Mortgage brokers, like bankers and other lenders, comply with every federal law and regulation affecting the mortgage loan origination industry. Additionally, mortgage brokers comply with a host of state laws and regulations affecting their businesses, from which bankers and lenders are largely exempt.

Mortgage brokers are just one participant in a larger network of loan originators – including mortgage bankers, mortgage lenders, credit unions, and depository institutions – all competing to deliver mortgage products to consumers. There are actually very few substantive differences between these distribution channels when it comes to originating mortgages. The lines that once divided them have become increasingly blurred with the proliferation of the secondary mortgage market. Today, mortgage brokers and mortgage lenders are performing essentially the same function – they present an array of available loan products to the consumer, close the loan and then, almost instantaneously sell the loan to the secondary market (i.e., Fannie Mae or Freddie Mac).

Although consumers are often unable to distinguish one origination source from another, mortgage brokers stand singularly accused of operating on an unregulated basis. This accusation is plainly false. Mortgage brokers are regulated by more than ten federal laws, five federal enforcement agencies and at least forty-nine state regulation and licensing statutes. Moreover, mortgage brokers, who typically operate as small business owners, must also comply with a number of laws and regulations governing the conduct of commercial activity within the states.

Federal Regulation of Mortgage Brokers

Mortgage brokers are governed by a host of federal laws and regulations. For example, mortgage brokers must comply with: the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), the Home Ownership and Equity Protection Act (HOEPA), the Fair Credit Reporting Act (FCRA), the Equal Credit Opportunity Act (ECOA), the Gramm-Leach-Bliley Act (GLBA), and the Federal Trade Commission Act (FTC Act), as well as fair lending and fair housing laws. Many of these statutes, coupled with their implementing regulations, provide substantive protection to borrowers who seek mortgage financing. These laws impose disclosure requirements on brokers, define high-cost loans, and contain anti-discrimination provisions.

Additionally, mortgage brokers are under the oversight of the Department of Housing and Urban Development (HUD) and the Federal Trade Commission (FTC); and to the extent their promulgated laws apply to mortgage brokers, the Federal Reserve Board, the Internal Revenue Service, and the Department of Labor. These agencies ensure that mortgage brokers comply with the

aforementioned federal laws, as well as small business and work-place regulations such as wage, hour and overtime requirements, the do-not-call registry, and can-spam regulations, along with the disclosure and reporting requirements associated with advertising, marketing and compensation for services.

Mortgage Broker Regulation in the States

The regulation of mortgage brokers begins at the federal level, but it certainly does not end there. Mortgage brokers are licensed or registered and must comply with pre-licensure and continuing education requirements and criminal background checks in forty-nine states and the District of Columbia. Additionally, over half of these states require not only mortgage broker licensure, but the licensure or registration of brokers' individual loan officers as well. An increasing number of states are requiring these originators to pass tests in order to become licensed. The same is not true for the thousands of loan officers employed by mortgage bankers and other lenders, who are exempt in most states from loan officer licensing statutes. While the Office of the Comptroller of the Currency exempts depository institutions from state licensing requirements, the states continue to increase their regulation of mortgage brokers and their individual loan officers. Many states also exempt lenders from licensing if they are approved by Fannie Mae or HUD, which subjects those lenders and their employees to significantly less regulation than most mortgage brokers.

As small businessmen and women, mortgage brokers must also comply with numerous predatory lending and consumer protection laws, regulations and ordinances (i.e., UDAP laws). Again, this is not true for a great number of depository banks, mortgage bankers, mortgage lenders and their employed loan officers, which remain exempt due to federal agency preemption. Many states also subject mortgage brokers to oversight, audit and/or investigation by mortgage regulators, the state's attorney general, or another state agency, and in some instances all three.

Conclusion

The mortgage industry is heavily regulated at both the state and federal levels; yet no amount of law or regulation will ever completely eliminate abusive practices from this or any industry. Placing additional restrictions on legitimate and law-abiding originators will not successfully address the problem of the truly unscrupulous lenders who brazenly ignore the laws as they currently exist. It is only through the enforcement of existing laws and the application of uniform legal standards to all originators that a lending environment will be created where consumers are free to shop and compare mortgage products and pricing among different distribution channels without fear or confusion.

Many of the current state and federal proposals to address abusive lending practices will simply not prevent predatory and abusive lending practices from occurring. Instead, these proposals could actually harm the consumer by restricting the choices of loan products, terms, and originators available in the market. Because each distribution channel is competing for consumers' mortgage loan business, consumers are best served when every mortgage originator is held to the same professional standards under the law.

Appendix C

US Department of Housing and Urban Development

Uniform Good Faith Estimate Statement

Name and Address of Borrower	Originating Company Name and Address: Loan #:
Property Address:	**Proposed Interest Rate:** % **Term of the loan:** Years
	Proposed Loan Amount: $
	Program Type: ☐ **Conventional;** ☐ **FHA;** ☐ **VA;** ☐ **Other:**
	☐ **Fixed Rate Mortgage Loan, or** ☐ **Adjustable Rate Mortgage Loan**
	Prepayment Penalty: ☐**May;** ☐**May Not** **Balloon Payment:** ☐ **Yes;** ☐ **No**

Settlement Charges:		**Summary of the Borrower's Transaction:**	
800: Items Payable in Connection With The Loan:		Contract Purchase Price	
801: Loan Origination Fee (%) to:		Existing Loan Amount to be Paid Off	
802: Loan Discount Fee (%) to:		Personal Property	
803: Appraisal Fee to:		Total Settlement/Closing Cost Charges to Borrower(s): **1400 A**	
804: Credit Report Fee to:		Total Pre-Paids/Reserves Charged to Borrower(s): **1400 B**	
805: Lender's Inspection Fee to:			
806: Application Fee to:		**Gross Amount Due From Borrower(s):**	
807: Flood Certification Fee to:		<Deposit of Earnest Money>	( )
808: Mortgage Broker Fee (%)		<Principal Amount of new loan(s)>	( )
809: Tax Service Fee to:		<Seller Paid Closing Cost Credit(s)>	( )
810: Processing Fee to:		<Subordinate Loan Proceeds>	( )
811: Underwriting/Admin Fee to:		<Other Credit(s)>	( )
812. Wire Transfer Fee to:		**Amounts Paid By or In Behalf of Borrower(s):**	( )
813:			
900: Items Required By Lender To Be Paid In Advance		**Cash at Settlement Due From/To Borrower(s):**	
901: Interest for days at $ /day			
902: Mortgage Insurance Premium for mos. to		**Proposed Payment(s):**	
903: Hazard Insurance Premium for mos. to		1st Mortgage ☐Principal & Interest pmt ☐ Interest Only pmt	
904: Flood Insurance Premium for mos. to		2nd Mortgage: ☐Principal & Interest pmt ☐ Interest Only pmt	
905: VA Funding Fee / Mortgage Insurance Premium		Property Taxes	
1000: Reserves Deposited with Lender: Waived ☐**Yes** ☐**No**		Home Owners Insurance	
1001: Hazard Insurance: months @ $ per mo.		Private Mortgage Insurance	
1002: Mortgage Insurance: months @ $ per mo		Homeowners Association Dues	
1003: City Property Taxes: months @ $ per mo.		Other	
1004: County Property Taxes: months @ $ per mo.		Other	
1005: Annual Assessments: months @ $ per mo.			
1006: Flood Insurance: months @ $ per mo.		**Total Proposed Monthly Payment:**	
1007: months @ $ per mo.			
1008:			
1100: Title Charges			
1101: Settlement or Closing/Escrow Fee to:			
1102: Abstract or Title Search to:			
1103: Title Examination to:			
1104: Title Insurance Binder to:			
1105: Documentation Preparation to:			
1106: Notary Fees to:			
1107: Attorney's Fee to: (Includes above item numbers:)			
1108: Title Insurance Fee to: (Includes above item numbers:)			
1109: Lender's Coverage $			
1110: Owner's Coverage $			
1111: Includes Commitment Fee to:			
1112: Endorsement Fee to:			
1113. Wire Fee to:			
1114: Electronic Doc Fee to:			
1115: Courier Fee to:			
1116:			
1117:			
1118:			
1200: Government Recording and Transfer Charges			
1201: Recording Fees: ☐Deed $ ☐Mortgage $ ☐Release(s)/Reconveyance(s) $			
1202: City/County Tax/Stamps ☐Deed $ ☐Mortgage$			
1203: State Tax/Stamps: ☐Deed $ ☐ Mortgage $			
1204: Assignment Fee to:			
1205: Subordination Fee to:			
1300: Additional Settlement Charges			
1301: Survey to:			
1302: Pest Inspection Fee to:			
1303: General Inspection(s) to:			
1304: Home Warranty Fee to:			
1305: Elevation Certificate Fee to:			
A: Settlement Cost (Sections 800, 1100, 1200, 1300 above) **B: Prepaid Items (Sections 900 and 1000 above)**			
1400: Total Estimated Settlement/Closing Costs			

Nature of Relationship: In connection with this residential mortgage loan, you the Borrower(s), has/have requested assistance from _____ (Company name) in arranging credit. We do not distribute all products in the marketplace and cannot guarantee the lowest rate.

Termination: This agreement will continue until one of the following events occur:

1. The Loan closes
2. The Request is denied.
3. The Borrower withdraws the request.
4. The Borrower decides to use another source for origination.
5. The Borrower is provided a revised Uniform Good Faith Estimate Statement.

Notice To Borrower(s): Signing this document does not obligate you to obtain a mortgage loan through this mortgage originator; nor is this a loan commitment or an approval; nor is your interest rate locked at this time unless otherwise disclosed on a separate Rate Lock Disclosure Form. Do not sign this document until you have read and understood the information in it. Fees received under this estimate are legal and permissible under the Real Estate Settlement and Procedures Act. You will receive a re-disclosure of any increase in interest rate or if the total sum of disclosed settlement/closing costs in **Section 1400A** increase by 10% or more of the original estimate. Should any such increase occur, mandatory re-disclosure must occur prior to the settlement or close of escrow.

Applicant(s) hereby acknowledge(s) the receipt of a copy of this Good Faith Estimate and that you/they inquired into real estate mortgage financing with _____ (Company) on _____(date).

Borrower: _____ **Co-Borrower:** _____

_____ **Originator** **Date** _____ **License # (if applicable)**

GFE ver.1.2

Appendix D

Model State Statute Initiative

Licensing, Pre-licensure Education and Continuing Education Requirements for All Originators

NAMB proposes a state statute initiative to protect consumers and ensure originator competency.

June 2002
Amended January 2005

The National Association of Mortgage Brokers (NAMB) is the national trade association representing the mortgage broker industry. With 49 state affiliates and more than 27,000 members, NAMB promotes the industry through programs and services such as education, professional certification and government affairs representation. NAMB members subscribe to a code of ethics and best lending practices that foster integrity, professionalism and confidentiality.

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Acknowledgements*

This Model State Statute Initiative is the result of a consensus process involving the Model State Statute Task Force, the NAMB Board of Directors and the NAMB Delegate Council and many internal committees.

NAMB wishes to thank President Joseph L. Falk, CMC, CRMS, for his leadership and commitment in proposing and promoting this major consumer protection initiative.

The Model State Statute Task Force provided inspirational leadership in developing the concepts and articles to be included in this Initiative. Thank you Mitch Medigovich, CMC, Leo Davenport, CRMS and Kate Crawford for your many hours of service and your clear thinking and thoughtfulness throughout the deliberative process.

Thank you to the Communications Committee, chaired by Al Wood, CRMS, NAMB's public relations firm of Merton G. Silbar Public Relations, Natalie Bachiri, NAMB's Director of Communications, NAMB's management firm, Association Management Group, as well as NAMB's legal counsel Robert Lotstein and staff of the firm of Lotstein Buckman.

The Legislative Committee, chaired by J.J. Sims and the Education Committee, chaired by Carol Gardner, CMC, CRMS, contributed mightily to the end product using their committee structure, committee members and other individuals to add to this national initiative.

We would also like to acknowledge and thank the NAMB Board of Directors and Delegate Council who have endorsed this proposal for protecting mortgage consumers.

* As of June 2002

Contents

Model State Statute Initiative

Introduction to NAMB's Model State Statute Initiative 1

Model State Statute Initiative 2

Recommended Course Curriculum 7

NAMB: The National Voice of the Mortgage Broker 14

June 2002

Dear Mortgage Professional:

Buying or financing a home is one of the largest, most complicated and vitally important decisions facing consumers in the United States. Therefore, residential mortgage loan originators who work directly with the public should be educated, honest and professional.

The National Association of Mortgage Brokers is proud to announce a comprehensive initiative to better serve and protect the public through increased licensure, training and education of all residential mortgage originators. The NAMB Model State Statute Initiative is based on NAMB's firm belief that part of the solution to consumer abuse and predatory lending is mandatory licensing and education of all residential loan originators.

NAMB is taking a proactive stance on consumer protection. This model statute serves as a model for state regulators and legislators whose states do not have such statutes or whose states need to improve their statutes to protect and serve the general public.

The concept has four basic tenets:

a) It should apply to all residential mortgage loan originators
b) There should be a state licensing requirement
c) There should be a pre-licensure education requirement
d) There should be a continuing education requirement to maintain competency

Our 44 state affiliates, which comprise NAMB, support this initiative and recommend that specific concepts for licensure and education be considered based on each state's current statute(s). NAMB recognizes that some states have aggressively monitored the industry through licensure and others have made education mandatory; whereas other states have determined different levels of oversight to regulate the mortgage industry.

While each state is different, NAMB believes that this initiative will serve to help reduce the incidence of predatory lending and improve the overall competency of the industry in every state. NAMB urges each state to adopt these concepts in the best interest of the public. NAMB is committed to see this matter through to fruition and will monitor the progress of this initiative in each state.

Our state affiliates will now lead the charge to protect consumers through enhanced licensing, pre-licensure and continuing education proposals to their respective state legislatures and mortgage regulators.

Thank you for your support of this proposal for State Licensure, Pre-licensure Education and Continuing Education for all originators.

Sincerely,

Joseph L. Falk, CMC, CRMS
President

NAMB Model State Statute Initiative

Goal: To better serve and protect the public, the residential mortgage loan industry will endeavor to license, train and educate all residential mortgage originators. NAMB firmly believes that part of the solution to consumer abuse and predatory lending is mandatory licensing and education of all residential loan originators.

Concept: Buying or financing a home is one of the largest, most complicated and vitally important decisions facing consumers in the United States. Residential mortgage loan originators who work directly with the public should be educated, honest, and professional.

Overview: NAMB is taking a proactive stance on consumer protection. NAMB seeks to have individual state statutes enacted that require pre-licensure education and mandate continuing education requirements for all residential loan originators. This model statute would serve as a model for state regulators and legislators whose states do not have such statutes or whose states need to improve their statutes to protect and serve the general public.

The concept has several basic tenets:

a) **It should apply to all residential mortgage loan originators**
b) **There should be a state licensing requirement**
c) **There should be a pre-licensure education requirement**
d) **There should be a continuing educations requirement to maintain competency**

NAMB believes that such an initiative will serve to help reduce the incidence of predatory lending and improve the overall competency of the industry. NAMB urges each state to adopt these concepts in the best interest of the public. NAMB is committed to see this matter through fruition and will monitor the progress of this initiative in each state.

All residential mortgage loan originators should have formal training and should be tested on their knowledge of matters including financial analysis, ethics, federal and state disclosures, real estate law, and mathematical computations germane to real estate and mortgage lending prior to contact with the public. Residential Mortgage Loan Originators should be well qualified before they work with homeowners on mortgaging or financing their most valuable asset.

For this reason, NAMB recommends and supports a standardization of education and experience for every person who holds themselves out to the public to be a Residential Mortgage Loan Originator.

Pre-Licensing Education

All persons making an initial application for licensing must:

a) Attend educational courses, determined by the state, when applying for a Residential Loan Officer license;
b) Attend educational courses, determined by the state, when applying for a Principal Mortgage Owner license;
c) Pass a test of core competencies;
d) Receive a certificate of completion from the school or organization that provided courses.

Each State or Licensing Authority should, with the assistance of the local mortgage professionals, establish review and approve curriculum sufficient to establish a baseline of knowledge for licensees.

Recommended Course Curriculum Pre-licensure course curriculum may include:

a. Federal Lending Laws;
b. Ethics, Diversity and Sensitivity;
c. Practices of Residential Lending.
d. Real Estate and Mortgage Mathematics;
e. Escrow Procedures, Title Insurance and Loan Settlement;
f. Appraisals and Land Survey;
g. Loan Processing and Loan Underwriting Process;
h. Secondary Mortgage Market;
i. Loan Default and Foreclosure Law;
j. State Statutes and Rules.

Continuing Education Requirements

Every residential mortgage originator, whether a Residential Loan Officer or Principal Mortgage Owner, shall, upon renewal of an existing license, submit proof of satisfactory completion of a course of study.

Subjects may include:

a) Federal and State Lending Law;
b) Local Rules and Regulations;
c) Ethics and Professional Standards;
d) General Real Estate or General Financial Studies;
e) Product Update;
f) Personal Development;
g) Diversity Training.

Continuing education courses may be offered through classroom instruction, electronic transmission, or distance learning. Qualifying hours may be obtained by attendance at a locally chartered real estate or mortgage business school, accredited college, university or community college, or vocational school or other institution approved by the state licensing agency.

The licensee should receive a completion certificate that such hours have been successfully completed. Licensees shall submit the appropriate completion certificate(s) with the license renewal form.

Licensing Overview

We believe that each state should enact a licensing requirement for all residential mortgage loan originators. The requirements for licensure should encompass all residential mortgage loan originators and all owners or responsible individuals of residential mortgage loan entities.*

Residential Mortgage Loan Officer Shall be defined as any individual who, for compensation or gain, takes or receives a mortgage application, assembles information, and prepares paperwork, and documentation necessary for obtaining a residential mortgage loan, or arranges for a conditional mortgage loan commitment between a borrower and a lender, or arranges for a residential loan commitment from a lender. Residential Mortgage Loan Officers also include an employee who solicits financial and mortgage information from the public for sale to another residential mortgage broker.

Principal Mortgage Owners/ Responsible Individual Defined as the owner, or managing general partner, or responsible individual, or any Officer, or stock holder, who holds themselves out to be the party accountable for residential mortgage loan originations or branch mortgage operations, with in the state, and/or the person in direct management of residential mortgage loan origination.

Exempt Any individuals who do not deal (i.e. negotiate interest rates, loan programs, offer loan locks, loan commitments) directly with borrowers. This includes persons who complete incidental services in arranging or procuring a mortgage loan, including administrative staff wherein their primary function is the verification of data provided by the borrower, assembly of documents and coordination of third party services such as ordering an appraisal, title report or credit reports.

Anyone who deals directly with a consumer and reviews, analyzes, evaluates a proposed borrowers financial statements, income, property characteristics and credit history should obtain a license.

Licensing Requirements

To obtain a state license to become a residential mortgage loan originator, the following concepts should be adopted:

1. A written application for licensure must be required. The application should require an attestation by the applicant as to the applicant's experience and knowledge of the mortgage industry.

2. The applicant should submit to a background investigation of, at a minimum, criminal records, and employment history.

    - No individual should be licensed who has had a license, or the equivalent, to practice any profession or occupation revoked, suspended or otherwise who has acted beyond legal limits.

    - No person should be licensed who has been convicted of acts against society that could be deemed 'moral turpitude'. Such acts where licenses should be denied must include duties owed by licensees to the public including acts contrary to justice and the doctrine of "fair dealing", honesty, principle or good business morals. This includes, but is not limited to theft, extortion, use of the mail to obtain property under false pretenses, tax evasion and the sale of, or the intent to sell controlled substances.

    - The licensee should provide evidence that they have managed their business and personal financial affairs with care and diligence.

3. A first time Residential Mortgage Loan Officer Licensee Applicant shall provide a certificate of satisfactory completion of a course of study, as defined by the state, consisting of the subjects listed below.

4. A Principal Mortgage Lending Entity/Owner/Responsible party Licensee Applicant shall provide a certificate of satisfactory completion of a course of study, as defined by the state, consisting of course work from the subjects listed below.[1]

5. A Licensee Applicant shall pass an examination of the applicant's knowledge after items 1-4above have been completed.

6. Licenses shall be valid for a two-year period. Upon expiration of the two-year period, the licensee should submit an application for renewal to the appropriate licensing authority. The renewal application should, at a minimum, include evidence of completion of continuing education courses, as described below.

7. The licensing authority should have the authority to request additional information from the Licensee Applicant to support statements made on the application or dispute matters discovered through investigation.

8. All initial applicants shall submit a finger print card, which shall be forwarded to the local Department of Public Safety and/or FBI for a records check.

9. The Licensee Applicant shall pay sufficient fees to pay for Licensing Authorities' costs of processing the license application and investigations.

10. Upon receipt of a Residential Mortgage Loan Officers license, the licensee shall immediately deliver the license to his/her employing broker. Upon termination of employment of a Residential Mortgage Loan Officer, the license shall be transferred to a new employing broker and the regulating authority should be notified. If the Residential Mortgage Loan Officer does not have a new employing broker, the license shall be returned to the Licensing Authority with an explanation or the reasons for termination.

11. The appropriate state regulatory authorities should maintain state licensing or registration records.

Grandfathered Persons

Every Residential Mortgage Loan Officer, currently registered, licensed or otherwise employed in the mortgage industry immediately preceding enactment of this initiative shall be permitted to continue employment as a Residential Mortgage Loan Officer. Each current originator shall be required to meet all of the necessary elements of licensure at the next renewal period specified by state law.

Unless provided for in state law, every Principal Residential Mortgage Lending Entity or Owner, currently licensed immediately preceding enactment of this initiative shall be permitted to maintain their license and position. Each current Principal Residential Mortgage Lending Entity/Owner shall be required to meet all of the necessary elements of licensure at the next renewal period specified in the state law.

---

[1] Based upon the experience of many mortgage brokers, the educational requirement should be greater than that required of Residential Loan Officers.

Recommended Course Curriculum

Pre-licensure course curriculum may include:

I. Federal Lending Laws. Licensees should develop competencies in matters of federal mortgage statutes, which may include:

a) Regulation Z, Truth in Lending Act;
b) Real Estate Settlement Procedures Act (RESPA);
c) Regulation B, the Equal Credit Opportunity Act;
d) Regulation C, the Home Mortgage Disclosure Act;
e) National Flood Insurance Act;
f) Fair Credit Reporting Act;
g) Federal Trade Commission rules concerning advertising for credit;
h) Servicing Transfer Act;
i) Privacy Act;
j) Consumer Protection Act;
k) Community Reinvestment Act.

II. Ethics, Diversity and Sensitivity. Licensees should be able to discuss the canons of:

a) Fair Housing Act;
b) Emerging Markets;
c) Redlining and Block-busting;
d) Ethical practices of mortgage lending.

III. Practices of Residential Lending. Licensees shall develop competencies in the subjects of:

a) Evolution of Residential Lending in the United States
b) The role of Government Sponsored Enterprises (GSE's)
c) Federal National Mortgage Association
d) Government National Mortgage Association
e) Federal Home Loan Mortgage Corporation
f) Federal Housing Administration
g) Veteran's Administration
h) Farmers Home Administration
i) Private Mortgage Insurance Industry Principles of Mortgage Lending, including but not limited to:
j) Assisting consumers in selection of loan programs including adjustable rate loans;
k) Evaluating the relationship between discount points and interest rates;
l) Describing the costs of originating a mortgage loan;
m) Preparing and discussing the required state and federal disclosures with a consumer;
n) Interpreting and discussing loan contingencies and covenants with the consumer;
o) Explaining the loan commitment issued by a lender;
p) Reading and understanding a real estate contract as it relates to financing of real property;
q) Identifying methods of holding title to real estate and discuss options with the consumer;
r) Describing the advantages of primary and subordinated financing options;
s) Explaining and preparing a Good Faith Estimate of costs for a consumer.

Conclusion

It is the intent of this initiative to engage measures to reduce the incidence of predatory lending and to raise the standards for those persons who interact with the public in the area of home financing. Every Residential Loan Originator should be licensed, responsible and accountable for his or her actions when working with the public. We at NAMB believe that establishing minimum educational requirements as well as requiring continuing education will substantially increase each Residential Loan Originator's awareness of their responsibility and duty to give consumers fair and honest service. It may be desirable for each state to consider establishing a mortgage oversight board to assist the commissioner with up-to-date material for pre-licensing and continuing educational courses.

*This initiative contemplates using the words 'license' and 'registration' interchangeably. We leave to the States to determine if this process includes an individual license, permit or an aggregated corporate registration methodology, so long as both aspects of educational requirements are maintained and criminal background investigations and prohibitions are maintained. If a corporate registration of all originators is contemplated, it should require 'employee' status and a bonding requirement should be considered. It is understood that if such a corporate methodology is utilized, paragraph 10 under Licensing Requirements is not applicable.

IV. Real Estate and Mortgage Mathematics. Licensees should develop competencies in basic mathematics.

The licensee should have the basic skills to:

a) Calculate gross and net loan amounts to satisfy a consumers loan request;
b) manually prepare a Good Faith Estimate of costs and Truth in Lending statement;
c) calculate and analyze ratios of mortgage payment-to-income;
d) calculate the ratio of total obligations-to-income to determine loan acceptability;
e) analyze income tax returns for self-employed borrowers to confirm sufficient income;
f) calculate loan to value ratios;
g) calculate origination fees, yield spread premiums and discount points;
h) calculate prorations for real estate taxes and insurance amounts for the reserve account;
i) calculate rate changes on adjustable rate mortgages;
j) convert hourly and weekly salaries to monthly income to compute ratios;
k) determine that the consumer has sufficient funds for closing;
l) calculate monthly principal and interest payments and the amortization of a loan;
m) calculate per diem interest amounts;
n) manually calculate the Annual Percentage Rate
o) describe the theory of Time Value of Money and the impact on the financing contract.

V. Escrow Procedures, Title Insurance and Loan Settlement. Licensees should develop competencies in matters of closing forms and the closing process. The licensee should be able to explain the documents and process so that the borrower fully understands what is taking place.

The documents to be explained include, but are not limited to:

a) the mortgage note and its provisions for default, the lenders rights and the borrowers rights;
b) the security agreement, (mortgage or deed of trust), including each of the covenants and conditions;
c) the HUD-1 closing statement and its relationship to the Good Faith Estimate of Costs;
d) the Good Faith Estimate of costs and final Truth in Lending statement;
e) the consumers right of rescission.
f) the purpose and cost of lenders title insurance;
g) the purpose and cost of owners title insurance;
h) title examination;
i) title abstract;
j) lien theory;
k) Schedule "B" exceptions to title insurance

VI. Appraisals and Land Survey. The licensee should be able to describe:

The three methods of valuation, including:
- cost approach;
- market approach;
- income Approach;

a) the theory of economic obsolescence;
b) the theory of functional obsolescence;
c) the theory of depreciation;
d) the theory of depletion;

e) the Rectangular Survey System;
f) the method of legal identification of real property in their state;
g) calculate the number of acres in a given area;
h) calculate the number of square feet in a given area.

The licensee should be able to understand and communicate with the borrower the purpose and process of the appraisal, the survey, title insurance, restrictive covenants, deed restrictions, and encroachments and pest inspections.

VII. Loan Processing and Loan Underwriting Process. Licensees should study the subjects of loan processing and underwriting. After study in this section, the licensee should be able to:

a) prepare, explain, and execute a business agreement with the consumer;
b) demonstrate the ability to understand and explain an FNMA 1003 mortgage application;
c) explain requirements for determining if the property, income and credit of borrower fit the loan offerings available through the licensee.

The licensee should have the knowledge to collect the necessary exhibits anticipated for:
a) underwriting contingencies;
b) understanding the procedures and requirements for issuing adverse action notices;
c) assembling for submission an entire loan package for underwriting.
d) evaluation of an appraisers conclusions.

The licensee should also have a basic knowledge of:
a) negotiating a rate lock;
b) investigation and confirmation of application data;
c) arranging for a property inspection;
d) evaluating and reviewing a title insurance policy;
e) owner's versus mortgagee's title insurance policies;
f) the function and operation of private mortgage insurance and knowing when it is required;
g) when private mortgage insurance can be canceled;
h) the meaning of the terms novation, assumption, and "subject to the mortgage";
i) release of liability.

The licensee should be able to demonstrate an understanding of the basics concepts of:
a) fixed versus variable rate mortgage loans;
b) negative and positive amortization principles;
c) graduated payment mortgages;
d) reverse mortgages;
e) shared appreciation mortgages;
f) bi-weekly mortgages;
g) temporary and permanent interest rate "buy-downs";
h) the concept of a wraparound mortgage.

VIII. Secondary Mortgage Market. Licensees should study the process of the secondary market. The licensee should be able to describe:

a) how interest rate markets are established;
b) interest rate risks;
c) the theory of "yield spread premiums";
d) the theory and process by which loans are sold;
e) the theory and purpose of a loan purchase commitment;
f) FNMA and FHLMC standard eligibility requirements;
g) the function and method of operation of FNMA, GNMA and FHLMC;
h) the method and marketing aspects of a GNMA mortgage-backed pass-through security;
i) the theory of "service release premiums".

The licensee should also be able to explain the basic functions of;
a) mortgage servicing;
b) collections;
c) remittance of payments;
d) escrow accounts for taxes and insurance;
e) payoffs ;
f) assumptions;
g) the transfer of servicing rights.

IX. Loan Default and Foreclosure Law. Licensees should study Foreclosure Law. Licensees should be able to describe:
a) the type of foreclosure law most frequently used in their state;
b) the legal process of a judicial foreclosure;
c) the legal process of a trustee's sale and how it differs from a judicial foreclosure;
d) the borrower's rights of reinstatement;
e) the borrower's right of redemption;
f) the legal process of a forfeiture of equitable title;
g) the effects of subordinate liens after foreclosure;
h) the effects of mechanics and materialmens' liens;
i) the process of tax lien sales.

X. State Statutes and Rules. Licensees should study of State and local law. Licensees should be able to identify:
a) minimum record keeping requirements;
b) record retention requirements;
c) minimum requirements for licensing;
d) the process for examination of a licensees records;
e) standards for accounting;
f) standards for maintaining Trust Funds;
g) minimum net worth requirements;
h) minimum bonding requirements;
i) local disclosure requirements;
j) contracts and written agreements with consumers;
k) minimum requirements for supervision of employees;

The National Voice of the Mortgage Broker

Established in 1972, the National Association of Mortgage Brokers (NAMB) is the national trade association representing the mortgage broker industry. With 49 state affiliates, and more than 27,000 members, NAMB promotes the industry through programs and services such as education, professional certification and government affairs representation. NAMB members subscribe to a code of ethics and best lending practices that foster integrity, professionalism and confidentiality.

A mortgage broker is an independent real estate financing professional who specializes in the origination of residential and/or commercial mortgages. There are approximately 33,000 active mortgage broker operations across the nation that employ an estimated 240,000 people and originate 65% of all residential loans in the U.S.

A mortgage broker is also an independent contractor who markets and originates loans offered by several wholesale lenders. By offering superior market expertise, and direct access to many different loan programs, a mortgage broker provides the consumer the most efficient and cost-effective method of obtaining a mortgage that fits the consumer's financial goals and circumstances. Mortgage brokers originate more mortgages than any other single loan source group in this nation.

The brokerage industry plays a significant role in the mortgage lending process and American economy, increasing competition and driving down costs. The expansive mortgage broker network allows loan wholesalers of all sizes to immediately gain a national presence without incurring the great expense of national advertising and maintenance of branch offices.

The mortgage broker industry is regulated by 10 federal laws, five federal enforcement agencies and over 45 state laws or licensing boards. Additionally, brokers typically have some type of Quality Control requirements and NAMB members also adhere to a strict Code of Ethics and best lending practices.

Revised 03-26-2007

Testimony of

Alex J. Pollock
Resident Fellow
American Enterprise Institute

To the Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services

United States House of Representatives

Hearing on Subprime and Predatory Lending

March 27, 2007

Subprime Mortgage Lending Problems in Context

Madam Chairman, Ranking Member Gillmor, and members of the Subcommittee, thank you for the opportunity to testify today. I am Alex Pollock, a Resident Fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I spent 35 years in banking, including 12 years as President and CEO of the Federal Home Loan Bank of Chicago, and am a Past President of the International Union for Housing Finance. I have both experienced and studied many credit cycles.

As we all know, the great house price inflation of the past several years has topped out, and the unsustainable expansion of subprime mortgage credit which accompanied it has shifted distinctly into reverse. As many people have pointed out, the market is itself correcting sharply and rapidly, if belatedly. The subprime boom is over; the bust is here. Former enthusiasm has been replaced by large financial losses, the bankruptcy of subprime lenders, layoffs, accelerating foreclosures, fear, a liquidity squeeze—and of course recriminations, some well deserved.

What was recently seen as "creative" and "innovative" democratization of credit is now viewed as misguided and culpable bungling or worse.

Historical Patterns

All these elements of the current subprime mortgage lending bust display the classic patterns of recurring credit over-expansions. Such credit celebrations are based on optimism and a euphoric belief in the ever-rising price of some asset class, in this case, houses and condominiums, providing a sure-fire way to make money for both lenders and borrowers. They are inevitably followed by a hangover of defaults, failures, dispossession of unwise or unlucky borrowers, revelations of fraud and scandals, and late cycle regulatory and political reactions.

In the general pattern, nothing changes. You would think we would learn, but we don't. As the great student of financial behavior, Walter Bagehot, observed in 1873:

"The mercantile community will have been unusually fortunate if during the period of rising prices it has not made great mistakes. Such a period naturally excites the sanguine and the ardent; they fancy that the prosperity they see will last always, that it is only the beginning of a greater prosperity. ... Every great crisis reveals the excessive speculations of many houses which no one before suspected."

We had a period of remarkably rising house prices. This stimulated the sanguine and ardent subprime lenders, and it stimulated the sanguine and ardent subprime borrowers. If the price of the asset is always rising, the risk of the loan seems less, and it appears that more leverage is always better. Booms are usually accompanied by a plausible theory about how we are in a "new era"; the subprime mortgage boom was no different.

It is essential to remember that the boom gets going because many people experience financial success. This so-far successful speculation is extrapolated. Subprime lenders were experiencing large profits and high stock prices. Subprime borrowers could get loans and buy houses they would otherwise be unable to and could benefit greatly from house price appreciation. A borrower who took out a 100% loan-to-value, adjustable rate mortgage with a teaser rate to buy a house which subsequently appreciated 30%, now had built substantial equity and the ability to refinance on more favorable terms. This was a successful outcome as a result of taking risk. But then somebody ends up buying at the top on a highly leveraged basis.

It is first success, and observing other people's success, which builds up the optimism, which creates the boom, which sets up the bust.

Home Ownership and Risk

The American home ownership rate has moved up to 69%. This was widely praised and is on balance a good thing. Some commentators have wondered whether this was not pushed too high, since home ownership is not for everybody. It is hard to say what the ideal home ownership ratio is.

The current American ratio is not particularly high on an international basis. According to an International Union for Housing Finance analysis, the U.S. ranks tied for 10th, 11th and 12th with Britain and Australia in home ownership among advanced economies. A number of countries maintain ratios greater than 75%. On the other hand Switzerland, a prosperous and pleasant country, has home ownership of only about 35%.

We can say that the mortgage market is constantly experimenting with how much risk there should be, how that risk is distributed, and how that trades off with success or failure. The subprime mortgage market obviously overshot on risk creation and is now paying the price. But if lenders and investors are free to take on credit risk, and if borrowers are free to take risk in order to have the chance to own a house, credit cycles are inevitable as these experiments proceed.

In general, it seems to me that if you want the long term growth, innovation and economic well being for ordinary people that only market experimentation can create, then you will have the boom and bust cycles that come along with market experimentation. I don't believe they can be avoided, except in hindsight.

Consider another notable experiment with mortgage lending: the creation of the long-term, fixed rate, amortizing mortgage loan. There is no doubt that this form of mortgage loan is highly attractive to borrowers. Introduced in the 1930s in response to the complete collapse of the mortgage market, it has been very successful in many ways.

But in the structure the 1930s set up to deliver this form of housing finance—namely the savings and loan industry—the long-term fixed rate mortgage was the basic cause of another complete and very expensive collapse: the savings and loan bust of the 1980s, which many of us remember vividly.

In economics, nothing is ever free. To preserve the fixed rate mortgage no longer provided by savings and loans in the 1980s, it was necessary to depend on vastly expanded securitization. Securitization typically breaks the link between the originator of the mortgage loan and who actually bears the credit risk. This usually results in riskier and less careful lending.

The financing engine of the subprime mortgage boom was securitization. This structure has greatly suffered, as is now clear, from just this break in credit decisions from credit risk bearing.

I believe that in an ideal mortgage finance system, the loan originator should always maintain a significant credit risk position in the loan, which creates a superior alignment of incentives-- this is always my advice to developing countries as they consider housing finance ideas. The subprime mortgage financing system is very far from this ideal.

Mortgage Risk

Mortgage finance has some very reliable systematic risk factors, and the subprime mortgage boom had all these risk factors operating together:

-Subprime loans have higher defaults and losses than prime loans

-Adjustable rate loans of all kinds have higher defaults and losses than fixed rate loans

-High LTV loans have greater defaults and losses than low LTV loans

-Periods of very rapid house price inflation result in greater defaults and losses than those of steady house price movements.

Current statistics reflect these risks. Subprime ARMs have 50% higher serious delinquencies than subprime fixed rate loans (9% vs. 6%). Subprime ARMs have six times the serious delinquencies of prime ARMs (9% vs. 1.45%) Prime ARMs have twice the serious delinquencies of prime fixed rate loans (1.45% vs. 0.7%).

The foreclosure rate on subprime mortgages of over 4% is below its recent peak of over 9% in 2000, but it is rising quickly. The subprime market is much larger than it was in 2000, having grown from about $150 billion to $1.3 trillion or over 8 times since then. So its economic and political impact is much greater.

The foreclosure rate for the oil patch mortgage loan bust of the 1980s peaked at 14.9% for the states of Arkansas, Louisiana, Mississippi and Oklahoma—an extreme experience used for stress tests by the bond rating agencies. If subprime mortgage foreclosures should approach this level, one analyst estimates losses to lenders of $100 to $150 billion and the loss of their homes by 1.5 million people.

It was not that subprime mortgage lenders did not understand these fundamental factors—it was that the risk reality outstripped the expectations of the models. As an old friend of mine says, "The model works until it doesn't." Perversely, the more everyone believes the model, and the more everyone uses the same model, the more likely it is to induce changes in market that make it cease to work.

Fraud

A risk difficult to model is fraud. Booms tend to induce fraud, misrepresentation and scandals. To quote Bagehot again:

"The good times of too high price almost always engender much fraud."

Or the great economic historian, Charles Kindleberger:

"The propensity to swindle grows parallel with the propensity to speculate during a boom. The implosion of an asset price bubble always leads to the discovery of fraud and swindles."

The subprime mortgage boom is true to its type in this respect also. Of course, the fact that fraud and misrepresentation always occur does not mean they should be excused or tolerated. Integrity in describing the terms of a loan is essential.

As a sign of the times, National Mortgage News has introduced a new weekly "Fraud and Compliance Report," responding to what it calls "the explosion of mortgage fraud." Note, however, that it is often the lenders who are being defrauded.

Consider in this context the spread of "stated income" loans. The disastrous previous experience with this bad idea, then called "no doc" or "low doc" loans, seems to have been unfortunately forgotten. Such loans are an obvious temptation, or even invitation, to exaggeration of income in order to obtain the mortgage loan. Hence the now familiar name of "Liars' Loans."

Of late, subprime borrowers with defaulted loans have sometimes been referred to as "victims." In my view, however, anyone who lied about their income to get a loan hardly qualifies as a "victim." Perhaps the lie seemed a small thing compared to getting to buy the house whose price will always keep on rising.

What Should Be Done Now?

What should be done now? Late in the credit cycle, when losses are rising, credit is tightening, liquidity is disappearing and asset prices are already falling, regulators face a dilemma. The former mistakes and scandals are already clear, and they should respond somehow, but how to take action that is not pro-cyclical and will make the current problems worse?

In my view, the "Proposed Statement on Subprime Mortgage Lending" of the combined financial institution regulators is in general a sober and sensible attempt to balance these pressures. The credit and disclosure principles they expound seem to me prudent and basic banking, which is rightly combined-- in the Request for Comment--with concern about the risk of procyclical negative market effects because of the late cycle timing. How to achieve the final balance appears still open. As always, there is the further risk of a difference between carefully balanced words in a policy statement and their application by potentially overzealous field staff.

The proposed disclosure principles in general seem sound and fundamental. A good lender wants the borrower to understand what the loan agreement is. In particular, it is essential to disclose simply and clearly any prepayment penalties and the pattern of

interest rate changes, if any, to which the loan is subject. I will say more about disclosure below.

I find it interesting that the proposed statement does not address down payment or LTV issues, since an equity stake in the house is an essential credit factor, and savings an essential economic factor. As one mortgage banker said recently, "Lenders will have to tell some borrowers to save for a down payment." Imagine that! Perhaps mortgage finance needs to rediscover saving as a principle.

There has been recent discussion in Congress and elsewhere of the possibility of some kind of fund to refinance defaulted subprime mortgages. The FHA is often mentioned in this context, although it is a credit insurer, not mortgage investor. Also, its delinquency rate is at the same level as the subprime sector, which suggests that loosening its credit standards further may not be the best idea. And we should certainly not be bailing out subprime lenders and investors—they should be on their own.

In considering this issue, I have been able to find one historical precedent: the Home Owners' Loan Corporation (HOLC), created by the Home Owners' Loan Act of 1933. In the midst of the housing finance system collapse of that time, the Act was to "protect the small home owner from foreclosure and relieve him of part of the burden of excessive interest and principal payments." Giving its bonds in exchange for defaulted mortgage loans, it provided refinancing for about 20% of U.S. mortgages. HOLC ended up itself foreclosing on about 20% of its own loans. Upon liquidation in 1951, it returned a small surplus to the Treasury.

Of course, our problems of today do not begin to approach those of 1933. But I suggest that HOLC could be usefully studied by anybody thinking about this issue.

The One-Page Disclosure

When considering borrowers in financial trouble, whether from unwise borrowing, not having understood their risks, having been fooled, or even induced into loans by misrepresentation, there is a natural desire to try to protect them.

I believe the superior strategy is to equip them to protect themselves, by ensuring short, simple and clear disclosures of mortgage loan terms. Most of us have had the experience of being overwhelmed and befuddled by the huge stack of documents full of confusing language in small print presented to us at a mortgage closing, which result from legal and compliance requirements, including regulatory attempts to insure disclosure.

I would like to see the design of a one page form which gives the essentials of the loan, which would be given to every mortgage borrower a week before the closing. This page should contain the following:

-Amount of loan

-LTV ratio

-Final maturity

-Prepayment fee, if any

-Balloon payment, if any

-Points and closing costs

-Initial rate on loan in % and monthly payment in dollars

-How long this rate is good for=when higher rate starts

-Fully indexed rate on loan in % and monthly payment in dollars

-Your household income on which this loan is based

-Initial monthly payment as % of income, and payment plus taxes and insurance as % income

-Fully indexed monthly payment as % income, and payment plus taxes and insurance as % income

-A name, number and e-mail for you to contact with any questions

-An authorized signature of the loan originator

-The signature of the borrower.

As I said, a good lender wants an informed and understanding borrower. Just as you get a prospectus for an investment, you should have to get a one page form something like this before you enter a mortgage loan agreement. But this page must be something simple and clear: 90% of the relevant information which is clear and understandable is better than 100% which is complex and opaque.

Thank you again for the chance to be here today.

March 27. 2007

Good morning, Chairwoman Maloney, and all members of the Subcommittee. My name is Madeline Holder, and I am the Executive Director of C.H.A.N.G.E.R. (Communities Homeowners and Neighbors Gaining Economic Rights) in New York City. For over 4 years C.H.A.N.G.E.R. has been working with homeowners in New York City. During this time our *'Justice For Homeowners'* campaign has successfully worked on Predatory Lending and Deed Theft issues. We were part of State-wide advocacy efforts that led to New York State Deed Theft Protection Act, which was passed in July 2006 by the New York State Legislature, and took effect this past February 2007.

C.H.A.N.G.E.R. is a homeowner advocacy organization that was borne in direct response to the assault against homeowners, and potential homeowners, particularly in low and moderate communities that has emerged as a result of the housing boom, gentrification, and explosive growth of irresponsible lending practices in New York City and across the nation in the past 10 to 15 years.

Recent events in the world of financial markets and banking have drawn light to the many injustices and unscrupulous lending practices that have been prevalent in sectors of the home lending market for the last few years. Our organization is one of just many advocacy organizations across the country that has been trying to raise awareness, and sound the alarm, about these injustices and practices by allowing for the voice of the homeowner to be heard. Articles about how homeowners in New York City have been defrauded or misled into predatory and/or unaffordable loans have appeared in the New York Times (attached) and in other local community newspapers in New York City.

Today, I would like to share with you the voices of two of our member homeowners who have had direct experience with the fraudulent and deceptive practices that have unfortunately prevailed in the market for homes, and that have led to widespread abuses against consumers within our nation.

HOMOWNER TESTIMONIALS:

Michelle Fayez-Olabi

I am a wife, a mother of six children, a homeowner and resident of Rosedale, Queens in New York City. In the winter of 2001, due to the fact that my husband and I were in between jobs and facing foreclosure, we received a flyer in the mail from Option Plus Mortgage. The flyer said: *Stop Foreclosure. Refinance, Bad credit, bankruptcy we can help.*

We made an appointment with a mortgage broker from Option Plus Mortgage. His office was located on Central Avenue in Valley Stream on Long Island seven minutes from our house. We paid this person an application fee of $800 dollars. The fee was for the purpose of processing the application and included a premium that was charged to applicants with poor credit. We were told not to worry! With our credit scores, Option Plus Mortgage could easily refinance our home. We applied, on the day of the closing, our representative came to our home with another individual whom we met for the very first time. Our representative from Option Plus Mortgage told my husband and I that this person we just met was going to co-sign for us to save our home from foreclosure, but that after one year his name would be removed from the mortgage. On that same day during the closing, we signed a lot of documents. Most of the pages we signed were blank. We were told that we should return a couple days later for a

copy of the entire set of documents we signed. A couple of days later, we tried to get the signed document, we were told that they are not ready, and then there are no records of them at all.

Soon after the closing, my husband and I learned that the individual that was brought to our home on the day of the closing by our Option Plus representative was now the new owner of our home, and we learned this only through the New York City housing court eviction proceedings papers that arrived at our home. We immediately contracted the services of an attorney to defend us in the eviction proceedings. That's when my husband and I found out for the very first time, that our home had been sold, and not refinanced! The house was sold for $ 368,000.00, a

$100,000 more than the refinance plan amount we agreed to. My husband and I did not receive a single penny from this transaction.

We were forced to exhaust all of our finances to fight against the fraud that was being perpetrated against our family. This placed us in a very precarious financial state. On the coldest day of January 2004, while our children were having lunch, after half a day of school, and while I was at work, the door bell rang. My mother, who was caring for the children, answered the door. It was a New York City Marshal, and he was executing an eviction warrant. He said to my mother: "You have ten minutes to leave the house."

Imagine having to leave your home that you have worked so hard to buy, we had five children and I was pregnant with our sixth child, on one of the coldest days of the year we were evicted, not from our apartment, but from the home we owned! We had no clothes, no food, no money no shelter over our heads. We were made homeless in a blink of an eye. Our tenants were also told to leave, and therefore made homeless too. Our things were packed for us by Mr. Mayfield from Option Plus Mortgage in our absence and put a private storage.

A broker from Option Plus Mortgage (which represented First Franklin Financial) offered to sell the house to our tenants. Our tenants refused any such offers. Our tenants and us lived like family for seven years, nonetheless the eviction caused such friction and obstacles in our relationship that we lost their friendship. One day we were sleeping in the comfort of our home. The next day we were sleeping on the floor of my in-laws' already crowded three-bedroom apartment. After this incident, our world was brutally shaken. Our children demanded an explanation from us. We were demoralized because we could not see how our crisis was going to be resolved. We were affected in every way one could be affected by such crime. Our four year-old son started to hide on the floor of the van whenever we drove by police officer cars, because he was so impacted by seeing the Marshal remove us that morning from our home. My husband and I both felt ashamed, and that we were incompetent and had betrayed our family. My mother could no longer stay with us to assist with the children. I was traveling from Manhattan to Rosedale, Queens to drop the children off, then from Queens to Brooklyn to work. The children and I passed daily by our stolen home without being able to enter. We were all exhausted, stressed, frustrated.

Today we are still living in Queens, in a two-room basement apartment owned by a Christian sister from my church with my six children, my husband and my mother. No one wants to rent to a family with six children. Today my family and I are still suffering. My children have lost their peaceful sleep. They all have nightmares about the loss of their home. It is only the grace of GOD that has kept our family healthy, strong and hopeful that we will get our house back. We were victims of Deed theft.

Deed theft is now a crime in New York State. I ask you today to see what happened to my family as yet one more example of how the subprime and predatory lending crisis that is ravaging across this country is impacting families by spawning and giving rise to related practices of property flipping, foreclosure rescue scams, and Deed theft that are fueling the affordable housing crisis in low and moderate income communities across this country. I urge this committee to act now! Increase regulation for subprime lending, regulate mortgage brokers and private financial lending companies, increase regulation of the secondary market, and most importantly pass a national Anti-Predatory Lending Act.

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Lionel Ouellette

I am writing this because communities of color all across the country are being destroyed. The last six years of rampant predatory sub-prime lending has wreaked havoc on my community. As a homeowner and community member I look to members of Congress to do something strong and powerful for homeowners.

I bought a house in 2001 for $215,000.00 which was top dollar at the time. Our mortgage payment was $1800.00. We bought the house for $8,100.00 total out-of-pocket money. The house recently appraised for $450,000.00. What is the house really worth? What does is it mean when realtors, bankers, the crooked one- stop-shop who originally sold me the house say, "your house is worth so much more now"? We could barely afford it at $215,000.00, what does $235,000 of equity do for me?

I remember family and friends talking about buying homes. They would compare property taxes, quality of the schools, safety, activities for kids, size of house, size of lot, etc. Now I know that poor people get the worst deals when it comes to housing, health-care, food, and financial services. We are told we didn't do our homework, we didn't investigate enough, or that we were complicit. I have a Master's degree and was teaching high school humanities in the New York City public school system. I was not and am not stupid, uneducated, gullible, lazy, or to blame for the situation I and too many of neighbors are in.

The company that sold me my house, United Homes of New York, has been investigated by the F.B.I., is in Eastern District Federal Court, and has been confronted by many of its former clients. United Homes of New York is currently a leader in new house building in Brooklyn and Queens.

The cost of housing has gone up so much that we spend upwards of 50% to 75% of our income to have a place to sleep; whether we rent or own. So my neighbors and I who own homes struggle to make our mortgage payments. The falsified appraisal reports we were given by United Homes were good enough to be approved by United Homes' bank but not good enough to transform a one-family home into a legal two-family home. Matter of fact, there is no 2nd kitchen on the second floor of my house.

From the beginning keeping up with the mortgage was tough. Faulty wiring, no insulation, and leaky pipes translated to additional out of pocket expenses, usually absorbed by revolving credit card debt. Rising credit card debt due to increasing house expenses is not uncommon amongst low-income first time homeowners. The mortgage brokers were there to be of further assistance. The Fed kept mortgage rates down and the brokers peddled us ever worse loans with false promises with high interest rates and halloon payments and prepayment

penalties. Some of us refinanced and took out home equity loans many times only to eventually foreclose or sell and break even and bave to start over all again.

Six years in the same bouse and on the same block. We made sure, as newcomers to East New York, N.Y. to meet everyone on our block. We got involved in Green Gems Community Garden around the corner from us. We helped plan block parties. We were involved in bread and vegetable distribution in the garden. We organized film screenings and workshops in the garden. We survived police brutality as a community. We facilitated mediation between our neighbors/homeowners. We helped our neighbors pick their belongings up off the street after they

were evicted and foreclosed on. We laughed and celebrated and cried with our neighbors. We still laugh and cry and continue to build our community.

Every predatory loan, every refinance and home equity loan that unfairly profits on poor people, affects our community. As homeowners mortgage payments went up so did rents. As rents increased displacement and evictions increased. The people we laughed and cried and celebrated with were forced out of the community.

In research I did with a group called PeopleB4Profit, we found 3 out of 4 homeowners in low income communities of color lose their homes within 6 months to 3 years from the purchase date. We were looking at the neighborhoods of East N.Y., Cypress Hills, and Jamaica in New York City. We found that 3 out of 4 homeowners fell down the following path. Three out of four homeowners did at least one cash out refinance, some as many as two or three, and eventually either were foreclosed on or sold their home. Now homeowners who sold were not making power moves. They were trying to survive and just getting by. Most who sold broke even or got an extra 10 or $20,000, which isn't even enough for a down-payment today.

What doesn't come across in statistics on predatory lending is the impact on families being displaced because of predatory lending. Children leaving their friends and the block they grew up on, changing schools, losing their bedroom, being homeless, and being put out on the street. We see increased stress on personal and intimate relationships, an increase in intimate partner violence, increased drug and alcohol abuse, increase in student drop-out rates, and increased instability on all levels.

Housing is so expensive that the most affordable housing is still unaffordable. These high sale prices guarantee high rents that are equally unaffordable. We once fought for access to banking and financial services. This is not what we had in mind. We want better deals. We want to continue building our community. We want banks to pay for the last 6 years of predatory lending and subprime lending. I want to see federal government intervention to benefit low income homeowners of color and not the banks that made these sub-prime predatory lenders. Let's not replace the S&L Crisis of the 80's with an even worse bailout. The Resolution Trust Corporation did not save homeowners and will not work this time. You have a duty to serve the people of this country. Help us to help ourselves. Serve us and not the bankers.

CLOSING STATEMENT

It is clear that a lending crisis exists, and that it has existed for sometime. 'Subprime' sector lending has been attracting all the attention of late, but our concerns extend beyond this sector to include consumers of Alt-A and Prime loans as well. It is simply not true that predatory and abuses practices are limited to the subprime 'market', they may predominate there but what is even more alarming is that fraudulent, deceptive, and abusive lending practices are clearly concentrated within low and moderate communities across this country.

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Unfortunately, it appears that only when the market experienced losses and lenders started to shut-down did real attention begin to be paid to this issue by regulators and the media. Similarly, first level crisis responses have led to regulators being more focused on the solvency of the institutions involved, and less on the complaints from consumers and the fallout consumers and communities are facing as a result of a clear environment of lax application of existing lending laws and regulatory powers.

In the beginning of the search for possible policy solutions, we propose at first-cut that an effort be made to enact a national Anti-Predatory Lending law, with real teeth, that is with sufficient enforcement vehicles included. Equally important is that the series of myths that have surfaced be understood for what they are, obfuscations of the true problem.

- You can not solely rely on 'Market Discipline' to correct this crisis, as there are too many incentives involved at too many levels to risk such faith. Capital markets in the home lending sector need much improved regulations, particularly in the packaging of mortgage-backed securities and liability on the part of secondary market purchasers.

- Regulation will not stifle credit for low income consumers. On the contrary, the present crisis has already produced a massive transfer of wealth out of low and moderate communities. What low income consumers really need is more assistance from Government Sponsored Entities, such as Fannie Mae, who have clearly dropped the ball in the present crisis and distanced themselves from their founding missions by growing their asset base, while not growing affordable housing in this country.

- People who have gotten mortgages over the past 15 years over the course of the housing boom, and concomitant growth of the subprime market, could have gotten better loans, and the asset bubble that emerged over the course of this period is more likely keeping many more families out of the reach of homeownership due to skyrocketing housing values.

Our organization welcomes any opportunity this committee may provide to discuss solutions for homeowners, as that is what is most needed in the present time. Thank you.

Sincerely,

Madeline Holder
Executive Director
C.H.A.N.G.E.R.

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CONSUMER MORTGAGE COALITION

March 26, 2007

The Honorable Carolyn Maloney
Chair
House Committee on Financial Services
Subcommittee on Financial Institutions
and Consumer Credit
2129 Rayburn House Office Building
Washington, DC 20515

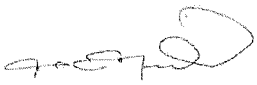
The Honorable Paul Gillmor
Ranking Member
House Committee on Financial Services
Subcommittee on Financial Institutions
and Consumer Credit
2129 Rayburn House Office Building
Washington, DC 20515

Dear Ms. Chairwoman and Ranking Member Gillmor:

The Consumer Mortgage Coalition respectfully requests that our testimony be submitted for the record to the House Committee on Financial Services Subcommittee on Financial Institutions and Consumer Credit for the March 27, 2007 hearing entitled, "Subprime and Predatory Mortgage Lending: New Regulatory Guidance, Current Market Conditions and Effects on Regulated Financial Institutions."

Thank you.

Sincerely,



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TESTIMONY SUBMITTED BY THE:

CONSUMER MORTGAGE COALITION

BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT

SUBPRIME AND PREDATORY LENDING:
NEW REGULATORY GUIDANCE, CURRENT MARKET CONDITIONS,
AND EFFECTS ON REGULATED FINANCIAL INSTITUTIONS

UNITED STATES HOUSE OF REPRESENTATIVES

March 27, 2007

The Consumer Mortgage Coalition ("CMC"), a trade association of national residential mortgage lenders, servicers, and service providers, appreciates the opportunity to submit its written testimony concerning recent developments in the residential mortgage market to the House Committee on Financial Services' Subcommittee on Financial Institutions and Consumer Credit.

CMC urges the Subcommittee to recognize that many of innovations by the mortgage lending industry and developments in the mortgage market are beneficial to consumers. CMC's testimony explains that innovations in the mortgage lending industry and secondary mortgage market have made mortgage credit more available and more affordable to consumers—of every race and ethnicity and of every income level—than at any time in our nation's history. Homeownership has increased in recent years to record highs.

CMC and its members acknowledge that the residential mortgage lending market is experiencing a period of correction, as it has in prior cycles.[1] CMC's testimony explains, however, that the market is working. In response to the recent up-tick in delinquencies and foreclosures, investors in the secondary mortgage market have tightened their investment guidelines. As a result, lenders nationwide quickly tightened their credit and underwriting requirements—and some lenders have even been forced to shut their doors, with others likely to follow. At the same time, the market continues to support practices and products that are beneficial to consumers and do not contribute to higher delinquency and/or foreclosure rates.

While the mortgage lending market is adjusting—and will continue to adjust—to the recent rise in non-prime delinquencies, as it has in prior cycles, the opportunity to own a home remains by far the most significant gateway to economic success for millions of Americans seeking to improve their and their family's lives. CMC and its members urge the Subcommittee to be cautious before taking steps to fix what is not broken.

CMC also notes that accounts of the recent correction and predictions for the future vary wildly. CMC's testimony notes that while some accounts and predictions are grounded in the facts, others are advocacy-driven and, in the experience of CMC's members, highly suspect. CMC urges the Subcommittee to have the Government Accountability Office conduct a study of delinquency and foreclosure rates so that the Subcommittee's decisions are based on credible data.

Additionally, CMC notes that one key to minimizing avoidable delinquencies and foreclosures is to ensure consumers understand the mortgage loan products they acquire. CMC has long advocated the simplification and clarification of consumer credit disclosures. Better disclosures, combined with the consumer education initiatives CMC

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[1] The market constantly adjusts the pricing and availability of credit to address changes and risks in the economy. While the effects of a too plentiful supply of credit can lead to adverse conditions, a too restrictive flow of credit, a "credit crunch," can also have devastating, ripple-effect consequences on our communities.

has advocated, will empower consumers to obtain those products that are beneficial to them without limiting their options. CMC and its members are continuing to consider additional measures that would strengthen the mortgage lending market and insure that vulnerable consumers are protected.

Finally, we note for the Subcommittee's attention two attachments to our February 7, 2007 testimony. The first is a non-prime lending primer, which discusses the history of non-prime lending, its benefits to consumers, and many of the terms that arise in debates regarding such lending. The second is an economics report issued by an economist at Friedman Billings Ramsey & Co. that sheds light on the underlying factors causing higher defaults and foreclosures, which is discussed in more detail below.

The American Dream of Homeownership

Homeownership has long been an integral part of the American dream. It not only benefits the individual homeowners, but also benefits communities and our nation generally. Practices which make the dream of homeownership more widely available and more affordable to consumers should be applauded, not limited.

Mortgage credit has not always been as available and affordable as it is today.[2] Prior to the 1990's, the vast majority of lenders would make only prime loans (i.e., loans to the lender's most creditworthy customers). Additionally, the number of mortgage products available to consumers was limited. Either the consumer met fairly rigid, conventional lending standards and received a prime loan or the consumer could not get a loan. And even when the consumer met those conventional lending standards, the products available to the borrower were limited.

If the consumer could not meet the conventional lending standards, the only market alternative was a finance company, which made mortgage loans with very high rates (often at double or more the rate on prime loans). Finance company lending standards were focused primarily on the value of the collateral (i.e., the loan amount was not a high percentage of the value of the property serving as collateral for the loan) and on the borrower's income. Loans were typically second mortgages for smaller amounts (under $50,000).

As technology improved and underwriting tools became more sophisticated, lenders (and investors in the secondary market) were able to assess the risk of different interest rates on individual loans. Lenders were not only able to offer a wider range of products better tailored to borrowers' varying circumstances, but could tailor the price of the product to the risk level of the individual borrower. The combination of innovative mortgage products and "risk-based pricing" benefits consumers generally. Consumers with good credit can obtain credit products at lower prices than ever before. Consumers that pose greater credit risk benefit not only by having greater access to mortgage credit than ever

[2] A more detailed, but still brief, discussion of the history of non-prime mortgage lending is included in the attachment to this testimony.

before, but also in having access to credit products that are more affordable than ever before.

Recent statistics show that the mortgage lending industry is furthering the American dream of homeownership. In recent years, homeownership has been at unprecedented highs. In the fourth quarter of 2006, the U.S. Census Bureau reported that U.S. homeownership was at a near-record level of 68.9%, up from 65.4% from the same quarter in 1996—meaning approximately 9.7 million more people own homes today than in 1996.[3] This time period roughly correlates with the development of the secondary market for non-prime mortgages and consequent expansion of the availability of non-prime mortgages. Homeownership among minorities also continues at near-record levels.[4]

The increased availability and affordability of mortgage credit—resulting in large part from innovative mortgage products and risk-based pricing—is an important factor leading to the increased homeownership in recent years.[5] Imposing inappropriate limitations on these products or on risk-based pricing will serve only to decrease the availability and affordability of mortgage credit, and undoubtedly will have a negative impact on homeownership rates. Such limitations will harm, not preserve, the American dream.

What Is, and What Is Not, "Predatory" Lending

While no universally accepted definition of "predatory lending" exists, it clearly is a term used to cast certain lending practices in a negative light. Some critics of certain lending practices have attempted to brand certain practices as "predatory." This term might rightly be applied to practices designed to cheat consumers out of their money and homes, but it is not properly applied to the vast majority of non-prime lending transactions which preserve and increase homeownership.

Notwithstanding the lack of a universally accepted definition of "predatory" lending, guidance by the Federal Reserve Board regarding predatory practices in home equity lending is instructive. Former Governor Gramlich has testified that there are two types of abusive practices in home equity lending, and mortgage lending generally: blatant fraud or deception, and the use of practices that are not inherently abusive but can be misused to injure consumers:

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[3] *See* U.S. Department of Commerce, *Census Bureau Reports on Residential Vacancies and Homeownership*, at 4 (Jan. 29, 2007), *available at* http://www.census.gov/hhes/www/housing/hvs/qtr406/q406press.pdf.

[4] *See id.* at 8.

[5] *See, e.g.*, Mark Doms & Meryl Motika, *The Rise in Homeownership*, FRBSF Economic Letter 2006-30, at 2-3 (Nov. 3, 2006), *available at* http://www.frbsf.org/publications/economics/letter/2006/el2006-30.pdf.

> "[A]busive practices in home-equity lending take many forms but principally fall within two categories. One category includes the use of *blatantly fraudulent or deceptive techniques* that may also involve other unlawful acts, including violations of HOEPA [the Home Ownership and Equity Protection Act]. These practices occur even though they are illegal. For example, loan applicants' incomes and ability to make scheduled loan payments may be falsified, consumers' signatures may be forged or obtained on blank documents, or borrowers may be charged fees that are not tied to any service rendered. The other category of abuses involves various techniques used to manipulate borrowers, *coupled with practices that may ordinarily be acceptable but can be used or combined in abusive ways*. . . . [S]ome loan terms that work well for some borrowers in some circumstances may harm borrowers who are not fully aware of the consequences. For example, a consumer may not understand that a loan with affordable monthly payments will not amortize the principal or that the consumer may have to refinance a balloon payment at additional cost."[6]

Predatory lenders who are disregarding existing legal requirements—including, in many cases, prohibitions against fraud and forgery that predate current consumer protections by many centuries—will not be deterred by additional rules. Instead, public policy should focus on more effective and sophisticated enforcement of those existing requirements.

The remedies for practices that ordinarily are acceptable but may be used in abusive ways depend on the particular practice and often on the particular circumstances. In its September 20, 2006 testimony before the Senate Banking Committee's Subcommittees on Housing and Transportation and Economic Policy, CMC discussed in detail many specific practices that are assailed by critics as "predatory."[7] The attached non-prime lending primer also discusses many of the legitimate and beneficial practices that are criticized as "predatory." CMC respectfully refers the Subcommittee to the discussions contained in those documents.

CMC urges the Subcommittee to recognize that many of the so-called "predatory" practices are, in fact, beneficial to consumers and contribute to making loan products available and affordable to those who most need them. Inappropriate limitations on such practices will result in a contraction in mortgage credit availability and a decrease in its affordability—neither of which preserve or further the American dream of homeownership.

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[6] Testimony of Gov. Edward M. Gramlich before the Committee on Banking and Financial Services, U.S. House of Representatives (May 24, 2000) (emphasis added).

[7] *See* Testimony of the Consumer Mortgage Coalition Before the Committee on Banking, Housing, and Urban Affairs (Subcommittees on Housing and Transportation and on Economic Policy), United States Senate, "Calculated Risk: Assessing Non-Traditional Mortgage Products", at 9-17 (Sept. 20, 2006).

Need for GAO Study

Recent negative portrayals of the sub-prime mortgage market by advocacy groups—and, in particular, a recent foreclosure forecast—have created much excitement.[8] In the experience of CMC and its members, these negative portrayals are grossly exaggerated. While CMC's members observed a recent up-tick in mortgage foreclosure rates, given the cyclical nature of the mortgage market this up-tick was not unexpected. CMC urges the Subcommittee to have the Government Accountability Office conduct an independent study of foreclosure rates to ensure that the Subcommittee makes its policy determinations based on reliable data. One advocacy-driven study should not be the basis for important public policy decisions.

Moreover, even though foreclosures increased slightly, the evidence shows that the market is working. When delinquency and foreclosure rates ticked up in recent months, investors in the secondary mortgage market responded quickly by tightening their investment guidelines. In turn, this quickly led to lenders tightening their credit and underwriting requirements. A few lenders experiencing larger up-ticks were even forced to shut their doors. While this resulted in a great deal of excitement and media attention, there are indications that the market is correcting—and possibly has corrected—the problem. For example, according to ForeclosureS.com, a California-based provider of foreclosure property information, foreclosures decreased nationally in February, down 3.4 percent from January and 6.5 percent from December.[9] According to Alexis McGee, president of ForeclosureS.com, "The foreclosure numbers finally are beginning to reflect the stabilization in housing markets that we've been talking about for the last few months. . . . Of course time will tell for sure whether we've seen the bottom or not. However, other economic indicators reflect a leveling off between housing supply and demand and reinforce the opinion that the worst really is behind us."[10] The CMC and its members do not have a crystal ball—we do not know for sure whether the foreclosure rate is heading up or down. Still, we believe that, at a minimum, the ForeclosureS.com report indicates that the Subcommittee should carefully scrutinize the accuracy of the advocates' dire predictions.

Furthermore, it is the experience of CMC and its members that the vast majority of delinquencies and foreclosures—including those during the recent up-tick—are not due to loan terms or products, but are due largely to the same factors that have led to

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[8] *See, e.g.*, Ellen Schloemer, et al., *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Consumers* (Dec. 2006).

[9] *Foreclosures Down Nationwide, but not in Southeast*, BIRMINGHAM BUS. J., Mar. 5, 2007, *available at* http://birmingham.bizjournals.com/birmingham/stories/2007/03/05/daily3.html.

[10] *Id.* However, another report indicates that some of the recent reductions in foreclosure filings may be caused by an increase in loan investors' willingness to allow a "short sale" of the property to avoid the foreclosure. *Homeowners, Lenders Skirt Default, May Curb U.S. Housing Slump*, Bloomberg.com, March 21, 2007, http://www.bloomberg.com/apps/news?pid=20601103&sid=an4wlQaDRorE&refer=news. This, too, would indicate that the market is appropriately reacting to the changing market conditions.

delinquencies and foreclosures historically: job losses, divorce, and medical problems. The Mortgage Bankers Association of America recently observed the same thing:

> Mortgage delinquencies are still caused by the same things that have historically caused mortgage delinquencies: "life events," such as job loss, illness, divorce or some other unexpected challenge. Foreclosures following delinquencies may be caused by the inability to sell a house due to local market conditions after one of the above items has occurred.[11]

It has also been the experience of CMC and its members that when poor job markets and other negative economic factors prevail in an area, foreclosure rates tend to rise. For example, the consumer advocacy group North Carolina Justice Center has shown that while the numbers of foreclosures (not just the rates of foreclosure) decreased state-wide in North Carolina in both 2004 and 2005, the numbers of foreclosures in particular counties varied more widely.[12] Such variances are much more likely to be a result of local economic factors than the result of any particular lender practices, products or loan terms. Similarly, while housing values have increased nationally (and, in some states dramatically)[13] and foreclosure rates have decreased nationally,[14] in Detroit property values have decreased and foreclosure rates have increased, due largely to "a slumping local economy."[15] Additionally, while foreclosure rates decreased nationally in January and February, the Southeast experienced an increase.[16]

This is supported by the economics report, "Explaining the Higher Default Rates of the 2005 Origination Year" by Michael Youngblood, Managing Director, Asset-Backed Securities Research, Friedman Billings Ramsey & Co., published in June 2006 in The MarketPulse by LoanPerformance, a copy of which is attached. The report notes that while the default rate at 20 months of adjustable rate mortgage (ARM) non-prime securities was higher in 2005 than in 2003 or 2004, it was lower than the default rate at

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[11] Mortgage Bankers Association, *The Residential Mortgage Market and Its Economic Context in 2007*, at 31, *available at* http://www.mortgagebankers.org/files/News/InternalResource/48215_TheResidentialMortgageMarketandItsEconomicContextin2007.pdf.

[12] *See* http://www.ncjustice.org/media/library/668_freclsrestatsncadminoffcts.pdf. While the numbers of foreclosures increased in some years, these numbers can only be understood properly in the context of the total new homes, which also increased.

[13] *See U.S. House Price Appreciation Rate Steadies*, http://www.ofheo.gov/media/pdf/4q06hpi.pdf (Mar. 1, 2007).

[14] *See, e.g.*, *Foreclosures Down Nationwide, but not in Southeast*, BIRMINGHAM BUS. J., Mar. 5, 2007, *available at* http://birmingham.bizjournals.com/birmingham/stories/2007/03/05/daily3.html.

[15] *See, e.g.*, Kevin Krolicki, *Houses Cheaper Than Cars in Detroit*, http://www.reuters.com/article/topNews/idUSN1927997820070319 (Mar. 19, 2007).

[16] *See Foreclosures Down Nationwide, supra*.

20 months on similar securities originated from the years 2000 through 2002.[17] Moreover, the report concluded that the reason the default rate on these securities was higher in 2005 than in 2003 or 2004 was attributable not to increases in short-term interest rates, nor to the erosion of underwriting criteria, but to weak economic factors in specific metropolitan statistical areas (MSAs) of the country, for example, weak labor market conditions in areas where non-prime borrowers depend on employment by automobile manufacturers and related companies, particularly, but not exclusively, in the Midwest, weak labor markets in New England, and the impact of Hurricanes Katrina and Rita on Louisiana and Mississippi.

In summary, the CMC believes the foreclosure picture to be very complicated in terms of severity, causation, and geographic dispersion, and not susceptible to glib generalizations about particular loan products or the direction of property values nationally. Indeed, one senior policy maker familiar with the situation has stated he believes the news media have "overreacted" to the correction in the mortgage lending market. In a recent speech, HUD Deputy Secretary Roy Bernardi stated that while "[s]ome of the concerns are justified because of the cooling in the housing market," he stressed that in his view the recent housing boom was unsustainable and that no one should be surprised by the market correction. Nevertheless, Secretary Bernardi emphasized he believes "this cooling-off period will be a short-term adjustment, and it will eventually be healthy for our economy."[18]

Some advocacy groups have also put forward anecdotal stories to support their calls for government action. Many of these anecdotes, however, involve fraudulent lender practices. Lenders who engage in fraudulent practices already ignore currently existing prohibitions on such practices. New limitations on loan products and terms will not deter such bad actors, but will only serve to limit the ability of responsible lenders to provide affordable credit to those who need it.

Such anecdotes are also selected to maximize negative impact. They do not include the millions of stories of consumers who have been able to purchase and retain homes, build equity, and pay emergency expenses as a result of mortgage credit. The sad reality is that there will always be some number of consumers who default on their loans. But, that number has been and continues to be relatively small. The misfortunes of a few should not deprive the many of opportunities to own their own homes and to make their own financial choices. CMC urges the Subcommittee to consider the many success stories when considering the negative anecdotes.

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[17] Additionally, in the experience of CMC and its members, non-prime hybrid ARM loans remain a small fraction of residential mortgage loans made nationwide.

[18] Roy Bernardi, Deputy Secretary, Department of Housing and Urban Affairs, Remarks at the 2007 Legislative and Regulatory Conference of the National Association of Mortgage Brokers (Mar. 20, 2007), *quoted in National Mortgage News Daily Briefing*, Mar. 21, 2007.

CMC also urges the Subcommittee to consider the many steps lenders and servicers take to avoid foreclosures. Lenders, servicers, and investors lose substantial amounts of money on each foreclosure. A Federal Reserve study has noted that

> When a borrower defaults on a home mortgage, the lender may attempt to recover its losses by repossessing and selling the property. However, estimated losses on these foreclosures range from 30 percent to 60 percent of the outstanding loan balances because of legal fees, foregone interest, and property expenses.[19]

Because a failed loan transaction is costly to all concerned, lenders design their underwriting criteria to avoid foreclosures. Lenders monitor closely the performance of loans and adjust their underwriting standards to avoid making loans that will default. Lenders and servicers also have developed programs to help borrowers through financial difficulty where possible, including encouraging customers to work with HUD-approved credit counseling agencies and offering flexible repayment plans. Lenders and servicers are better off if they can find ways to help the borrower avoid default. And, to the extent foreclosures increase, market forces compel lenders and servicers to tighten underwriting criteria and take steps to assist borrowers in avoiding default and foreclosure. Indeed, recent reports indicate that lenders are taking unprecedented steps to help borrowers avoid foreclosures.[20] From the perspective of lenders and servicers, foreclosure is a highly undesirable, but occasionally necessary, last resort.

Nevertheless, CMC urges the Subcommittee to consider the negative impact any limitation on foreclosure ability will have on the availability and affordability of mortgage credit to consumers. Mortgage credit is cheaper than unsecured credit because lenders and servicers can foreclose if the borrower defaults. While foreclosure usually falls far short of making the lender or investor whole, it serves to reduce the loss the lender/investor faces on the defaulted loan. If lenders and servicers are limited (either intentionally or inadvertently) in their ability to foreclose when a borrower defaults, the lender or investor will face a vastly increased risk of loss which will be reflected in higher prices and decreased availability of mortgage credit—a result that will deprive many Americans of the dream of homeownership.

Informing and Educating Consumers is the Key

Both consumers and lenders are better off if lenders have the freedom to offer and consumers have the freedom to choose from the widest range of financial options. Legislation and regulation that limits choices or stymies new product development reduces the ability of the market to serve consumers. Consumers, however, must be put

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[19] Karen M. Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, at 2 (May 13, 2003), *available at* http://www.federalreserve.gov/pubs/feds/2003/200316/200316pap.pdf.

[20] *See, e.g.*, *Homeowners, Lenders Skirt Default, May Curb U.S. Housing Slump*, Bloomberg.com, March 21, 2007, http://www.bloomberg.com/apps/news?pid=20601103&sid=an4wlQaDRorE&refer=news.

in a position to make an informed decision that is most appropriate for their needs and situation. And, consumers must be able to choose financial products that meet their goals and needs, consistent with their ability to repay and with safety and soundness concerns. Instead of imposing external limitations on lenders activities or products, or limiting lenders/servicers ability to foreclose on delinquent loans, CMC suggests that improved methods of educating consumers about their loans is a preferable means of minimizing delinquency and foreclosure.

1. Improving Disclosures

The best way to address pricing or other concerns in the non-prime market is to encourage more competition and more entry into the market, not less. Only competition will be able to reduce prices and increase consumer choices in this market.

A simplified, understandable disclosure of key information about the loan would enable consumers to better understand their credit obligations and comparison shop for loans—and create the competition necessary to benefit consumers. A common feature of most allegations of predatory lending is that the borrower was either confused or deliberately misled about key features of the loan. If the borrower receives a clear disclosure of these key features early in the transaction, it will be more difficult for an abusive lender or broker to misrepresent the terms of the loan and the borrower will have time to seek financing from other sources if the terms are unfavorable.

It is critical that lenders be able to comply with a uniform set of disclosure and other substantive requirements that will consistently and adequately protect consumers across the nation. New or modified disclosures must both (1) be short and in a form consumers can digest so as to avoid both "information overload," and (2) clearly describe changes in payments or interest rates to minimize instances of "payment shock."

CMC has for over a decade advocated for simplification and clarification of consumer disclosures, beginning in HUD's Negotiated Rulemaking on mortgage broker compensation that began in 1995 through an extended process seeking mortgage reform, whether through legislation or regulation, and through several rounds of HUD efforts to update and improve its RESPA regulations. We continue even today to work with other trade groups, HUD and others to improve the RESPA disclosure scheme. The extended duration of these efforts indicates that there are no easy answers. For example, while requiring that Good Faith Estimates provided under RESPA be more precise may have some superficial appeal, "closing surprises" are rarely due to changes in lender charges but rather arise from settlement service providers over whom the lender has no control. If Congress hopes to make RESPA disclosures useful for consumers, Congress will need to address a number of underlying issues, including ensuring that lenders have a greater ability to control the costs they disclose and have the ability to average cost price.

Additionally, in the majority of cases, the mortgage broker is the initial and often principal contact with the consumer in the process of shopping for and understanding the range of loans available and the potential impact of a loan on the consumer's financial

situation. Thus, brokers must be required to provide clear, meaningful and timely information to the consumer about both the products available, the role the broker is playing (i.e., consumer's agent, lender's agent or other role), and the total compensation the broker will receive in the transaction.

2. Improving Consumer Education

In addition to advocating improved disclosures, the CMC has long advocated a robust three-step program to increase public awareness and improve consumers' understanding of their loan obligation:

a. Public Service Campaign

Federal policymakers should implement an ongoing, nationwide public service campaign to advise consumers, but particularly the more vulnerable such as senior citizens and the poorly educated, that they should seek the advice of an independent third party before signing any loan agreements. Public service announcements could be made on radio and television, and articles and notices could be run in local newspapers and selected publications.

b. Public Awareness Infrastructure

Once alerted, consumers will need to be able to avail themselves of counseling services from unbiased sources. Those sources can always include family and friends and industry participants. In addition, however, a nationwide network should be put in place to ensure that all consumers can easily access advice and counseling to help them determine the loan product that best fits their financial needs. A public awareness infrastructure could be built out that would include 1-800 numbers with independent counselors, using sophisticated computer software, to help consumers talk through the loan product they are considering. In addition, programs could be developed with community organizations and other organizations serving senior citizens to provide on-site counseling assistance at local senior and community centers and churches. HUD's 800 number for counseling could be listed on required mortgage disclosures as an initial step to increase awareness of available advice.

c. "Good Housekeeping Seal of Approval" for On-Line Mortgage Calculators

Over 8 years ago, the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development issued a *Joint Report on the Real Estate Settlement Procedures Act and Truth in Lending Act* ("Joint Fed/HUD Report") recommending, among other things, that the government develop "smart" computer programs to help consumers determine the loan product that best meets their individual needs. Obviously, great strides in technology have occurred since then, with many mortgage calculators or "smart" computers available online. Since these computer programs have been already developed by the private sector and are widely available, a

more appropriate role for the government today would be for the federal government to approve a limited and unbiased generic mortgage calculator module that could be incorporated into any online site that helps consumers evaluate various loan products.

We note that this hearing takes place just shortly after National Consumer Protection Week (NCPW) (observed this year February 4-10). The theme of NCPW for this year was "Read Up and Reach Out: Be an Informed Consumer," and it aims to encourage people to take advantage of the wealth of information available from government agencies and national and local consumer organizations that can help individuals make smart buying decisions and avoid frauds. This could not be more apropos to the issues being addressed today. The CMC takes consumer education very seriously and believes it is the best way to enable people to protect themselves. In the words of FDIC Chairman Sheila Bair, "We know that when people learn how to make smart financial decisions and guard against fraud, they are protecting themselves and their family as well as their local community."

CMC is convinced that both consumers and lenders are better off if lenders have the freedom to offer and consumers have the freedom to choose from the widest range of financial options. Consumers, however, must be put in a position to make an informed decision that is most appropriate for their needs and situation.

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The CMC appreciates the opportunity to submit its testimony on issues relating to the recent correction in the residential mortgage lending market.

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Madam Chairwoman and distinguished members of the subcommittee, The Mortgage Broker Association for Responsible Lending is grateful for this opportunity to submit testimony on subprime and predatory lending. The Mortgage Broker Association for Responsible Lending (MBARL) is a trade association that represents the real estate finance industry, an industry that employs more than 400,000 professionals throughout the country.

While other trade associations representing professionals in this field are dedicated to education, professional certification and equal guidelines throughout the industry, we at the MBARL focus on the loan programs themselves. By investigating the pros and cons of certain loan programs for both the prime and sub prime markets we are an advocacy group protecting consumers and the loan industry by outlandish and counter productive loan programs.

When it comes to subprime lending I can not think of a harder subject to give written testimony on. Why? Because there is not a common and uniform definition of what a subprime loan is. I hope that this confusion will be discussed and resolved at the beginning of the hearing. This will be important for future hearings along with discussions that go beyond the current subprime melt down. The confusing verbiage is not exclusive to subprime lending, when dealing with benchmarks and borders between different types of loans there is currently a large grey area for alt-a, and prime lending as well.

Being a mortgage professional, I will be the first to admit that I do not know a uniform and widely accepted definition for a subprime loan. For years I have been using the same mentality Supreme Court Justice Stewart used when he gave his opinion on what is hard-core pornography, "I know it when I see it." In the current lending environment, where a day can not pass by without opening a newspaper and reading an article about subprime mortgages, this mentality will not cut it.

I will leave my remarks to state that generally subprime mortgages deal with low credit scores. These low credit scores can usually be attributed to consumers who are over extended with debt, consume and spend too much, have a history of not paying there bills on time, and possibly have a bankruptcy in their past. This classification runs throughout the spectrum of Americans. A subprime borrower can be found in all cultures and races of America both rich and poor. They can be located on either coast and everywhere in between. Rural areas and large city's have constituents of people with blemished credit histories.

Subprime mortgage lending through "creative" loan products have allowed people across America to obtain a home, but in many cases obtaining a home is different than affording a home. In recent years far too many people took a shortcut to home obtainer-ship, often times these short cuts were facilitated with subprime mortgage lending, but not exclusively. These short cuts are a stark contrast compared to healthy real estate practices such as proving your income, saving for a down payment, and getting a loan where

principal is paid down every month. These "old styles" of lending have a long traditional proven track record, but in recent year have gone to the waste side.

I want to take a step back and explain the products that I am talking about when I speak of shortcuts. In many cases these new highly popular loan products were the only way for first time home buyers to obtain a home in a quick and easy manner with a "got to have it now" mentality. These shortcuts were miss-sold as affordability products and would have been better described as obtain-ability products. Long term affordability, which should be a goal by both consumer and lender, is not associated with these toxic shortcuts. The home obtainer-ship shortcuts consisted of the encouraged use by the consumer and loan officer to lie about the borrower's income and employment status on mortgage applications through "stated income loans", 0% down payments, negatively amortized loans, interest only loans, and short term suicide loans where the fixed loan period is only 2 or 3 years. Commonly the suicide loans are tacked on with an equally long prepayment penalty. Many times the menu of the above mentioned loan options would be coupled together.

In a real estate correction cycle the first casualties lost to foreclosure will be first time home buyers who took shortcuts, often but not limited to subprime lending. First time homebuyers are the key to a good real estate market. An old rule of thumb is that with every first-time home buyer entering the market there is a filtering up which creates three more transactions. A large reason why the real estate cycle for the last 5 years has been so successful is because banks have been able to provide toxic mortgages to first time home buyers to get prematurely into the market. With these recently foreclosed people now out of the real estate market in 2008, 2009, and beyond, where will that natural progression of first time home buyers come from? With a foreclosure or bankruptcy on there record there will be a lack of quality of candidates to become first time home buyers in the future. This will cause the future recovery to take longer than in previous real estate corrective cycles.

Going beyond first time home buyers there are many other subprime borrowers who have lived in their homes before 2001, before the rapid appreciation in the market. The equity gained for many has been enormous. Many have used this equity over and over to be consumers, in all aspects of the word. As a mortgage broker we like to call them serial refinancers, and they are great for business. Unfortunately millions of Americans are not going to be able to live in their house anymore because they lived <u>on</u> their house for years by taking out the equity.

Multiple factors brewing for many years have lead to the current down spiral of the subprime mortgage industry. The largest culprit would be the unethical business practices throughout the real estate industry which has allowed people to come back time and time again to the newly acquired equity in their homes and use this "funny money" as a piggy bank. With traditional underwriting and sound/ honest appraisals much of the equity would otherwise never have been allowed to be tapped into. Unethical practices that are far too common in today's environment are;

- Inflating people's income on the mortgage application through stated income loans. The false income is derived through a simple mathematical formula with key variables being given by the banks on their daily rate sheets.
- Inflating appraisal's to a high enough value to "make the deal work"
- Loan officers, and mortgage brokers using high pressure sales tactics, and often times leaving out key pieces of information. The key information would otherwise be buried with disclosure in oftentimes 80+ pages of legal jargon.
- Allowing, and in many cases encouraging, unreported income to be used in the underwriting process. This type of money laundering gives tax cheats an advantage in the home buying process.
- Selling commission heavy loan products for inappropriate homeowners

There is an enormous amount of pressure given to appraiser by loan officers and mortgage brokers. The appraiser is there to protect both the consumer and the lender from making bad financial decisions. An accurate non pressured appraiser can give a consumer a warning that they might be paying too much for a home, and can give an equally important warning to the banks that they are risking too much money on a home loan. Unfortunately with the current appraisal ordering process this pressure will keep going on, and neither party will be getting the warning they deserve.

Many people that obtained homes through toxic loans that allowed them to overstretched there incomes, either through fraud or through improper loan programs. By doing so consumers overstretched their means to be able to keep up with the monthly mortgage payments. Many sales pitches that sounded great were to short sided. If legislation restricts guidelines, and especially if future legislation requires proof of income, you will not prevent a single person from purchasing a home, you will prevent Americans from the risky practice of buying too much home.

Possible federally enacted solutions to combat current problems in the real estate industry are;

- Require banks that do originate stated income loans, to turn over the income written on the mortgage application to the IRS for auditing purposes.
- Have the SEC restrict stated income loans from being sold on the secondary market. If a bank is willing to take the risk of originating a loan without proof of income the bank should be required to hold onto that risk.
- Not allow banks to use unreported income for underwriting purposes
- Simplify current oversight mortgage regulating agencies. In CA there are at least 8 agencies that would oversee mortgage origination, 5 are federal and 3 are state agencies. There should be one.
- Mandatory licensing and education for all loan officers and brokers throughout the US. Currently with direct lenders and other mortgage originators an 18 high school drop out in Michigan can be calling and selling loans across state lines to an elderly woman in New Mexico.
- Mandatory criminal background checks for all loan officers and brokers throughout the US. Currently a felon one day out of jail can originate loans

and have access to client's social security number, bank account numbers, credit history's, and job information.

- A single nationwide appraisal online ordering system. This would prevent loan officers and mortgage brokers from cherry picking favorite appraisers who have a standing history and relationship to inflate values. It would also prevent giving undue pressure towards appraisers to "hit" a predetermined value.
- Restrict the use of negatively amortized loans to owner occupied homes. Allow banks to only fund negatively amortized loans for investment properties and second homes.
- Require advertising disclosures for negatively amortized loans. An ad should disclose in non-fine print, "This advertised rate of ____ is not the actual interest rate. It is the payment rate. If the borrower chooses to pay this advertised rate, the principal balance of the loan will increase."
- Require that banks underwrite the loan with consideration for the full length and term, not just for the initial teaser payments.
- Limit the length of prepayment penalties on 2 year and 3 year fixed loans. There should be a 6 month window before the fixed period expires for consumers to be able to shop and get out of the loan through a refinance without incurring a penalty.

Subprime was a log to the fire of appreciation over the last few years. That log is dying out, and a portion of appreciation is dying out too. The market will begin to self correct. Years into the future I would hate to see banks come back or continue to use unethical business practice that are still all too common today. We are now at a time where we can put fraud and unethical behavior at a standstill in the industry.

In conclusion, the Mortgage Broker Association for Responsible Lending commends the subcommittee for holding this important hearing and for its leadership in tackling the subprime mortgage crisis we currently face. The MBARL is ready to work diligently with members of Congress and its staff to help forge a more sustainable and ethical real estate industry in the future.

Submitted,

Steven Krystofiak
President of the Mortgage Broker Association for Responsible Lending

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FRED R. BECKER, JR.
President and CEO

March 26, 2007

The Honorable Carolyn Maloney
Chair
Subcommittee on Financial Institutions
and Consumer Credit
House Financial Service Committee
United States House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Paul Gillmor
Ranking Member
Subcommittee on Financial Institutions
and Consumer Credit
House Financial Services Committee
United States House of Representatives
B371A Rayburn House Office Building
Washington, DC 20515

Dear Chair Maloney and Ranking Member Gillmor: Chairwoman Maloney

I am writing on behalf of the National Association of Federal Credit Unions (NAFCU), the only national trade association that exclusively represents the interests of our nation's federal credit unions, in conjunction with your hearing tomorrow entitled "Subprime and Predatory Mortgage Lending: New Regulatory Guidance, Current Market Conditions and Effects on Regulated Financial Institutions" to share our comments on this important issue.

Predatory lending in any form is unacceptable to the credit union community and NAFCU disapproves of any practices that take advantage of uninformed and unwary consumers by subjecting them to deception, misleading and incomplete information, falsifications, or outright fraud. In this regard, NAFCU strongly supports meaningful efforts to eliminate predatory lending practices in all sectors of the economy. NAFCU also believes there is little, if any, evidence of predatory lending practices by credit unions. Information from the Federal Reserve suggests that most predatory lending involves non-depository institutions and other lenders that are not subject to routine regulatory compliance audits and examination.

As you are aware, credit unions are member-owned not-for-profit cooperative financial institutions. Credit unions return any earnings to their members typically as reduced fees or reduced interest rates on loans or as dividends on shares, or reinvest those earnings in the credit union as retained earnings for purposes of safety and soundness. Also, credit unions rely on unpaid, volunteer boards of directors elected by, and drawn from, each institution's membership. This structure ensures the maximum responsiveness to members, thus resulting in outstanding service.

An analysis of the recently released 2005 Home Mortgage Disclosure Act (HMDA) Data, when compared to banks and thrifts, credit unions approve real estate loans that are smaller in size, approve a greater percentage of conforming real estate loans and have a greater percentage of real estate borrowers with less than $40,000 in income and to minorities.

Furthermore, our analysis of 2005 HMDA data shows that when credit unions grant mortgage loans to households with under $40,000 in income, a significantly fewer number of credit unions, when compared to banks and thrifts, are charging 3 percentage points or more above the Treasury benchmark for first lien loans and 5 percentage points or more for subordinated-lien loans. This is a new area of HMDA data reporting in 2004. Only 3.6% of credit union mortgage loans were above this reporting rate spread, as compared to 21% and 24% of loans for banks and thrifts. This is reflected in the chart below. Simply stated, credit unions are giving minorities and those with lower incomes, as group, a much

more reasonable mortgage loans than either banks or thrifts. This again demonstrates the benefits that credit unions provide their members over and above that provided by other financial depository institutions.

2005 Approved 1-4 Family Purchase Loans
Percentage of Approvals with Rate Spreads* >= Treasury Benchmark

Percentage Reporting Above Benchmark Spread	All Approvals (with race data)		White Approvals		Minority Approvals	
	Household Income		Household Income		Household Income	
	Less than $40,000	$40,000 or More	Less than $40,000	$40,000 or More	Less than $40,000	$40,000 or More
Credit Unions	**3.6%**	**2.4%**	**3.6%**	**2.4%**	**4.4%**	**2.3%**
Banks	**21.0%**	**15.4%**	**18.8%**	**13.7%**	**32.9%**	**24.8%**
Thrifts	**24.0%**	**16.6%**	**21.4%**	**14.9%**	**37.2%**	**24.6%**

*Approvals equal loans originated plus loans approved but not accepted. Rate spread is the difference between the annual percentage rate (APR) of the loan and the applicable Treasury yield of a comparable period of maturity. The rate spread is reported only if it is equal to or greater than 3 percentage points for first-lien loans and 5 percentage points for subordinated-lien loans. Minority approvals include those who identified themselves as Native American, Asian/Pacific, Black or Hispanic.

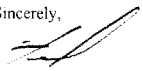
Source: Federal Financial Institutions Examination Council HMDA Data

The problems that Subcommittee will hear during the hearing are not problems within the credit union community. Federal credit unions are prohibited by law from engaging in some practices that have been associated with predatory lending. For example, federal credit unions cannot charge more than 15 percent per year on any loan (12 USC 1757(5)(A)(vi)), unless an alternative rate is established by federal regulation. (Today that rate is 18%). In addition, federal credit unions are prohibited from charging pre-payment penalties to their members (12 USC 1757(5)(A)(viii)).

Many credit unions have taken on the responsibility of serving individuals in underserved areas—areas which are often underserved because other financial institutions have left them behind. Ironically, the banking industry recently sued the National Credit Union Administration (NCUA) to make it harder for credit unions to add underserved communities. Earlier this month, Representatives Paul Kanjorski and Ed Royce introduced legislation in the form of H.R. 1537, the *Credit Union Regulatory Improvements Act* (CURIA), which would correct this injustice and allow all types of federal credit union charters to add underserved areas and help those that the banks have left behind. Enactment of this important legislation will help credit unions serve those who need it most and help combat those that would target them with predatory products and practices.

In conclusion, NAFCU would like to thank you for holding this hearing. We believe that credit unions are part of the solution to combating predatory lending and we look forward to working with you and the Subcommittee as you address this important issue. If you or your staff has any questions regarding this matter, please don't hesitate to call NAFCU's Director of Legislative Affairs Brad Thaler or me at 703-522-4770.

Sincerely,



Fred R. Becker, Jr.
President and CEO

Chairwoman Maloney -
As we discussed just a
couple of weeks ago, I believe
you will find credit unions to be
true leaders in combating predatory
lending!

cc: Members of the Subcommittee on Financial Institutions and Consumer Credit

NATIONAL ASSOCIATION OF REALTORS®

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HEARING BEFORE THE HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

ENTITLED

THE NEW REGULATORY GUIDANCE ON SUBPRIME HYBRID MORTGAGES: REGULATORS AND RESPONSE

STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®
MARCH 27, 2007

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

The National Association of REALTORS® (NAR) is pleased to submit our views to the House Financial Services Subcommittee on Financial Institutions and Consumer Credit for the hearing entitled, "The New Regulatory Guidance on Subprime Hybrid Mortgages: Regulators and Response." We commend Chairman Maloney, Representative Gillmor and members of the subcommittee for holding this hearing on the important issue of subprime hybrid mortgage products, which if not carefully underwritten, could place the borrower in a situation of greater risk of foreclosure and other financial harm.

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association representing more than 1.3 million members and five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®.

REALTORS® Want to Prevent Irresponsible and Abusive Lending

Irresponsible and abusive lending practices are a major problem for our nation's communities. While abusive lending occurs much too often in subprime markets, not all subprime loans are abusive or problematic. In fact, responsible subprime lenders have played an important role in helping millions of consumers achieve homeownership. Unfortunately, some lenders abuse their role and take advantage of vulnerable borrowers by charging extremely high interest rates and loan fees unrelated to risk, using aggressive sales tactics to steer consumers into unnecessarily expensive or inappropriate loan products, and advertising "teaser" interest rates (like the 2/28 or 3/27 adjustable rate mortgage) that steeply increase after the first few years of the loan. The consequences of abuses in the subprime market are higher foreclosures leading to the loss of a family's home and savings and increased vacancy rates which, in turn, can cause all homes in the neighborhood to lose value.

Real estate professionals have a strong stake in preventing abusive lending because:

- Abusive lending erodes confidence in the Nation's housing system.

- In a credit-driven economy, the legislative and regulatory response to lending abuses can go too far and inadvertently limit the availability of reasonable credit for prime as well as subprime borrowers.
- To the extent the response to abusive lending constrains the ability of the secondary mortgage market to provide liquidity for home finance, consumers will find it more difficult and expensive to buy a home.
- Citizens of communities, including real estate professionals, are harmed whenever abusive lending strips equity from homeowners, especially when the irresponsible lenders concentrate their activities on certain neighborhoods and create a downward cycle of economic deterioration.

Problems Connected to Abusive Lending

For years, we have all heard from both the industry and the regulators that there is no single definition of "predatory" lending because the term covers a wide range of abusive practices. Some practices may seem abusive for one borrower but not for another because everyone's circumstances are different. Abusive lenders often take advantage of first-time homebuyers and others who may be vulnerable. Some examples of problems with abusive loans include, but most certainly are not limited to:

- **High interest rates and fees.** Abusive lenders often charge extremely high interest and fees that are added into the total amount of the loan the borrower must repay. These lenders charge what they can get away with, not a fair amount based on the credit history of the borrower.

- **Broken promises/"bait and switch."** Sometimes home buyers are offered a new loan or a refinance of an existing loan that seems to meet all of their needs only to find that interest rates and fees have changed when they get to the closing table. Agreeing to last-minute changes can cost thousands of dollars and result in a loan they just can't afford.

- **Loans that start low and go high.** Adjustable rate loans are popular in today's market, but some loans, like the 2/28 or 3/27 mortgages which seem to be affordable at first, are likely to have steep cost increases in the future.

- **Loan "flipping."** Too many homeowners are persuaded to refinance their mortgage, sometimes repeatedly, when there is no real benefit. Even when a family receives some cash from a refinance, the gains should be weighed against the costs of excessive fees and a higher loan amount. Often a borrower has other options, such as obtaining a second mortgage instead of refinancing the entire existing mortgage.

- **Steering.** Some families who receive subprime loans could qualify for a much more affordable home loan, possibly even a prime loan. Abusive lenders use aggressive sales tactics to steer families into unnecessarily expensive loan products.

NAR Supports Amending HOEPA to Broaden and Strengthen its Coverage

NAR supports amending the Home Ownership and Equity Protection Act of 1994 (HOEPA), which establishes federal anti-predatory lending protections for high-cost mortgages. If Congress enacts significant HOEPA reform legislation, including many of the amendments listed below, NAR believes the result would be a significant reduction in irresponsible and abusive lending.

1. **Extend HOEPA to Purchase Money Mortgages.** The scope of HOEPA should be broadened to cover purchase money mortgages, and not be limited to refinancings and other loans taken out by existing homeowners. While abusive lending has been a particular problem in connection with refinancings by homeowners, homebuyers are also being victimized by problematic loans.

2. **Lower Triggers to Apply HOEPA to More Mortgages.** HOEPA applies to high-cost mortgages, measured in terms of high interest rates and high fees and points.

- The existing interest rate trigger should be lowered so HOEPA applies to more mortgages or lenders offer more lower cost mortgages, but the decision of exactly what level is appropriate will depend on the strength of the overall package of reforms. The current trigger for subordinate mortgages is 10 percent above the rate for comparable U.S. Treasury obligations. The Federal Reserve Board has exercised its discretion to lower the trigger to 8 percent for first mortgages.
- The definition of fees and points should be comprehensive (current law has too many exclusions), and the points and fees trigger should be set at about 5 percent of the loan. For example, the definition should include yield spread premiums and, if permitted, potential prepayment penalties. Some pending proposals would permit, in addition to the percentage cap, two bona fide discount points, which should be permitted, depending on the strength of the overall package of reforms.
- In addition, NAR recommends that Congress consider adding an additional HOEPA trigger based on excessive loan-to-value ratios, again with the details depending on the strength of the overall package of reforms. Since appraisal fraud—appraisals above the real market value of the property—may be coupled with abusive lending, NAR recognizes that an LTV trigger may have limited impact. NAR is on record in support of appraisals that are independent, unbiased, and objective for all segments of the market.

3. **Protections from Abusive Terms and Conditions.** NAR supports a strong package of HOEPA reforms that includes as many of the following protections for high-cost HOEPA mortgages (and, where noted, other mortgages) as possible:
   - Seek to bar **prepayment penalties** but for all mortgages, not just high-cost HOEPA mortgages. If a complete prohibition is not feasible, support shortening the maximum permissible time for prepayment penalties from five years to three or preferably fewer years and capping them at a reasonable amount.
   - **Cap the amount of fees and points that may be financed at about 5%, plus up to two bona fide discount points.** This would minimize the ability of abusive lenders to hide the true cost to the consumer by avoiding the need for them to pay for

excessive fees at settlement. Prohibit financing of fees and points in the case of a refinancing where the same lender made the loan being refinanced.

- Prohibit **single premium insurance** (or any equivalent).
- Prohibit **mandatory arbitration clauses,** because of the need to offer borrowers with HOEPA mortgages stronger protections. (Mandatory arbitration clauses are becoming infrequent in the prime market because Fannie Mae and Freddie Mac no longer purchase mortgages with mandatory arbitration clauses, and other lenders have stopped including them in their mortgages as well.)
- Continue to prohibit lenders from engaging in a pattern or practice of lending without regard to the **ability of the borrower to repay the loan.**
- For **home improvement contractor loans,** continue to prohibit direct payments of loan proceeds to home improvement contractors, and make assignees and holders of HOEPA home improvement mortgages subject to the same claims a consumer has against the seller, contractor, broker, or creditor.
- Prohibit anyone from **encouraging default.**
- Prohibit **mortgage flipping**—refinancing within one year unless the refinancing provides a "reasonable net tangible benefit" to the borrower.
- Require lenders, each year, to provide **two free pay-off statements** within seven business days of the request.
- As a general rule, permit **modification and deferral fees** only when there is a change to a HOEPA loan that benefits the consumer.
- Require all institutional mortgage lenders to **report payment history** of borrowers on a monthly basis. Prime mortgage lenders typically already report payment histories to credit reporting agencies (credit bureaus), so imposing reporting on all lenders should not impose an additional regulatory burden on prime mortgage lenders.
- Retain prohibitions against **balloon mortgages** for mortgages with terms less than five years and against **negative amortization**.
- Require **counseling** for prospective borrowers, to be provided by independent, certified counselors.

4. **Assignee Liability.** NAR opposes any weakening of originator or assignee liability for HOEPA mortgages. There is no reason originators should not remain liable for violations of law they commit in connection with making a mortgage loan. As between an innocent borrower that risks losing the home and an innocent assignee in the secondary market that inadvertently purchases a HOEPA mortgage, the interests of the borrower should generally prevail. Fannie Mae, Freddie Mac, and others have policies against the purchase of HOEPA mortgages, and current law has not impaired the secondary market.

   HOEPA currently imposes liability on assignees of HOEPA mortgages and permits borrowers to defend against foreclosure based on defects in the mortgage, with limited exceptions. A HOEPA mortgagor in default cannot assert certain claims and defenses against an assignee that can demonstrate, by a preponderance of evidence, that a reasonable person could not determine that it had purchased a HOEPA mortgage, based on certain factors. But even where an assignee can make that showing, the mortgagor retains certain rights, including the right of rescission for certain violations.

   NAR supports proposals to strengthen HOEPA, so long as they would not disrupt the secondary market. For example, HOEPA should continue to include reasonable limits on the amount of damages a mortgagor can claim, and class action litigation should not be permitted.

NAR Supports Consumer Education

NAR is very concerned that some borrowers do not understand the significant risks associated with an abusive loan and do not know how to avoid them. Last year, NAR, in partnership with the Center for Responsible Lending, issued a consumer education brochure entitled, "How to Avoid Predatory Lending," a copy of which is attached to this statement. The brochure emphasizes how important it is for consumers to make sure they shop for the lowest-cost loan and ask questions like,

- What is my credit score? Can I have a copy of my credit report?
- What is the best interest rate today? Do I qualify?

- Is the loan's interest rate fixed or adjustable?
- What is the term (length) of the loan?
- What are the total loan fees?
- What is the total monthly payment? Does this include property taxes and insurance? If not, how much will I need each month for taxes and insurance?
- Is there an application fee? If so, what is it, and how much is refundable if I don't qualify?
- Are there any prepayment penalties? If so, what are they and how long do they last?

Conclusion

Irresponsible and abusive lending can be a disaster not only for the borrower and his or her family, but for the community as well. Problematic loans are often made in concentrated areas and are more likely to result in foreclosures. High foreclosures of single-family homes are a serious threat to neighborhood stability and community well-being. Foreclosures can lead to high vacancy rates which, in turn, can devastate the strength and stability of communities.

REALTORS® help families achieve the dream of homeownership. The National Association of REALTORS® supports responsible lending with increased consumer protections to ensure that the "dream" our members help fulfill does not turn into a family's worst nightmare. NAR stands ready to work with Congress on the important issue of risky mortgage products and we are happy to make available to your constituents our "How to Avoid Predatory Lending" consumer education brochure. Thank you.

Sold a Nightmare- Concord subdivision proves lucrative for builder and costly for 1st-time owners

BINYAMIN APPELBAUM, LISA HAMMERSLY MUNN, TED MELLNIK
Staff Writers
Part one of four

CONCORD - Mark and Lea Tingley bought a new home in 2001 in a subdivision called Southern Chase. Photos on the family computer show a smiling young couple holding a baby girl in a bare room.

They recall feeling surprised they could afford a house. And thrilled. It was their first home, their largest investment, in the neighborhood where they planned to raise a family.

Beazer Homes USA built the Tingleys' home. Southern Chase was a new kind of subdivision for Beazer, an experiment in selling low-cost homes to low-income families.

The strategy was a financial success for Beazer.

But the neighborhood fell apart.

Seventy-seven buyers have lost homes to foreclosure in a subdivision of 406 homes. That's about one in five, more than six times the national rate.

Some homes sat empty. Others became rentals. Prices dropped.

Standing in his side yard last fall, Mark Tingley pointed to holes in his siding, garbage in neighboring yards, overgrown lawns, junked cars. He feels angry, cheated and trapped.

"We were just so happy," he said. "Now, no one is happy."

The buyers in Southern Chase share responsibility for the decisions they made.

But an Observer investigation found Beazer acted in ways that made a high rate of foreclosures inevitable. Beazer not only built the homes in Southern Chase, it arranged mortgage loans for two-thirds of the buyers. The company used that control to arrange larger loans than some buyers could afford. That allowed it to include the cost of financial incentives in the price of homes.

Some of Beazer's actions violated federal lending rules, the Observer found.

Beazer said its practices in Southern Chase were "in strict compliance with federal, state and local laws and regulations." The company said in a written statement that the foreclosures were mostly due to economic difficulties experienced by the buyers.

"Beazer is committed to providing quality homes of superior value," the letter read in part.

The company's CEO, Ian McCarthy, declined to speak with the Observer.

The Federal Housing Administration, which insured most of the mortgage loans, failed to address the problems. The government has paid more than $5 million to cover defaulted loans in Southern Chase. It continues to insure new Beazer loans.

The Department of Housing and Urban Development, which administers the FHA program, told the Observer it was not aware of the problems in Southern Chase and did not plan to investigate the loans it insured for buyers there.

Demand `hot as a match'

The night before Southern Chase opened in 1997, people camped outside the sales office, waiting to pick the best lots.Home prices started below $80,000, roughly half the Charlotte-area average. Demand was "hot as a match," said Barry Helms, the sales agent who greeted them. He remembers selling six or seven homes the first day.

The unusually low prices were a strategic decision for Beazer. Too many companies were building homes in the Charlotte area for traditional first-time owners, the company said in its 1997 annual report. Beazer's answer was to build and sell homes for less.

Beazer also was responding to opportunity. The federal government was pushing to expand home ownership. It was encouraging mortgage lenders to relax standards, to make loans available to many lower-income families for the first time. The FHA offered to insure the loans: If the borrower didn't pay, the government would.

Beazer, which operated in the Carolinas at the time as Squires Homes, chose a site off N.C. 49 in Concord, where land was still relatively cheap.

The subdivision is 15 minutes from Lowe's Motor Speedway, so Beazer gave racing names to the streets: Winners Circle, Rockingham Lane. It built vinyl-sided homes on small lots, mostly one story, an average of 1,327 square feet.

Contractors did the building. Beazer focused on marketing. It held pizza parties at nearby apartment complexes. It took tenants to see homes.

"We believe in the dream," read a Beazer flier distributed to apartments in Concord. "We believe that everyone deserves to own their own home."

But as the company pushed to find new buyers, it increasingly crossed the line between selling to people who could barely afford homes, and selling to people who couldn't.

Plunging in

Lea and Mark Tingley were not looking to buy a home in early 2001. They had little savings.

Lea made $11 an hour weighing trucks at a Martin Marietta rock quarry. Mark made a little less as a forklift operator at a building supply store.

They heard about Southern Chase from Lea's brother, who had just put a deposit on a home there. If he could afford a house, Lea recalls thinking, I can, too. The Tingleys drove out the next day from their Concord apartment.

They say the sales agent told them Beazer would arrange the down payment. The company also would arrange a mortgage. It would even help with the monthly payments for the first two years.

Lea remembers the sales agent saying, Let's just do this. You're pregnant. You need a home of your own.

She returned the next day with a $600 deposit.

The company spent about $9,000 on financial incentives for the Tingleys, including the down payment, most of the closing costs and help with the mortgage payments. The company offered similar financial incentives to most buyers from 2001 to the end of sales in 2004.

As Beazer's costs rose, the company raised the price of new homes in Southern Chase by an average of 10 percent per square foot between 2000 and 2002. That was twice the price increase for similar homes elsewhere in Cabarrus County.

The model the Tingleys purchased, the Talladega, had a base price of $96,490 on a 1999 price sheet. By 2001, Beazer had raised the base price for the same model with the same square footage to $108,990.

Buyers needed larger loans to pay the higher prices. Beazer arranged the loans through a subsidiary, Beazer Mortgage, which acted as a mortgage broker, matching customers with lenders for a fee of several thousand dollars. From 2001, Beazer Mortgage arranged loans for 84 percent of the buyers in Southern Chase.

Almost all of the loans were insured by the Federal Housing Administration. That meant Beazer and the lender had little to lose if the borrower could not afford the loan.

Beazer assured borrowers it was acting in their interest.

One buyer saved a brochure from Beazer's mortgage business that reads in part, "There are no salespeople in this office. The people you work with are working for you, to secure the best possible deal on your behalf."

Costly loan maneuvers

The Tingleys moved into their new home in April 2001. Lea cleared out her 401(k) to pay $2,500 toward closing costs.The keys came in a manila envelope with instructions on the front:

"1) Dump on table.

2) Place key on ring.

3) Do the `Happy Dance' (Jump up and down shouting wildly.)"

The thrill did not last.

Lea had applied for the loan without Mark because he had credit problems.

She omitted from her application a monthly payment of $350 on a leased Dodge Avenger.

Lea said a Beazer employee told her to do it because the application also didn't include Mark's income.

"At the time it made sense to me and I was just excited about owning the home," Lea said. She says she knows she shouldn't have omitted the payment, but she trusted the employee.

Loan documents show that Beazer Mortgage prepared a final version of Lea's application before the closing. On that final version, Lea's monthly income was overstated by $187. It had been correct on the original application Lea signed. It is unclear when the number changed.

FHA rules required Beazer to document the borrower's income and debts. Lea's credit report and W-2 show the accurate numbers.

Knowingly falsifying information on a loan application is a federal crime.

Lea says she didn't notice the change until the Observer pointed it out this fall.

The company did not respond to The Observer's written questions about the loan.

The changes allowed Lea to qualify for the loan she needed.

But in the summer of 2001, three months after buying the home, Lea called the dealership and asked to have the Avenger repossessed. She could not afford the car and the mortgage.

Buydown balloon inflates

The Tingleys' monthly mortgage payments started low because Beazer had agreed to pay part of the bill for two years. The company arranged similar deals, called interest-rate buydowns, for 146 other buyers in Southern Chase.

Under FHA rules at that time, paying part of the loan allowed Beazer to arrange larger loans than buyers could otherwise get. But Beazer had to document that buyers likely would have enough money to make the full payment by the third year. The Tingleys say they were never asked.

Other buydown recipients in Southern Chase included a clerk in an accounting office, a nursing home assistant and a trash collector. There was little chance their income would increase sufficiently. They also say they were never asked.

In June 2002, the Tingleys' monthly mortgage payment climbed from $675 to $744. Their income did not keep pace. Mark had quit work to care for the couple's daughter. They were unable to pay the full amount.

One year later, the monthly payment went up again, to $856, and the Tingleys fell further behind.

The bank that made the loan, National City, let them keep the home -- but only if they made larger payments to catch up.

They sold their furniture and replaced it with furniture from Goodwill. They sold gold coins given to Lea by her father. They ate Oodles of Noodles and lots of peanut butter.

They held on. Many of their neighbors did not.

2004 was the first year in which many buyers were making a full mortgage payment without Beazer's help.

The overwhelmed owners might have sold their homes to pay their debts. But prices in the neighborhood had dropped.

Too many homes were for sale. Foreclosed homes were available for 80 cents on the dollar. There were newer subdivisions nearby.

Many remaining residents owed more than they could sell their homes for, and they lacked the savings to pay the difference.

Martin and Jill Higginbotham tried to sell their home for two years after Martin took a job in Tennessee. Finally, Martin mailed in the keys and called the lender.

"Do what you have to do," he remembers saying.

The lender foreclosed in early 2004. Twenty-nine other owners lost their homes that year.

Mark Tingley took a part-time job. An auction house paid him to tend three foreclosed homes once occupied by his neighbors.

Can't afford to stay or go

The Tingleys had a plan when they moved to Southern Chase. They would sell after five years and move to a larger home.

By last fall, their daughter was 5, their son was 3 and the 1,410-square-foot house felt small. But the Tingleys owed more than $115,000 on a house valued for tax purposes at less than $108,000.

They talked with real estate agents, who quoted even lower prices.

The Tingleys were struggling to pay their mortgage. The monthly bill had climbed to $1,091, including catch-up payments. They didn't have the savings to sell the home at a loss.

"We can't afford it, we can't sell it and we're hurting ourselves just trying to keep it," Lea said.

Her credit has become so bad she said she can't open a bank account.

She and Mark worry they will lose the home the next time they fall behind on the mortgage payments.

They worry the home is falling apart: There is mold in the carpet where it meets the walls. Vinyl siding is cracking and popping. Wooden trim is rotting.
They could walk away and accept foreclosure.

But they say they're not ready.

They worry most of all that this will be the last home they ever own.

Starter homes, sad endings-Number of foreclosures climbs as 1st-time buyers lose low-priced houses

BINYAMIN APPELBAUM, LISA HAMMERSLY MUNN & TED MELLNIK
Staff Writers

A wave of loan defaults in starter-home developments is pushing the foreclosure count in Mecklenburg County to record heights, an Observer analysis shows.

Lenders foreclosed last year on more than 900 Mecklenburg starter homes, up more than 150 percent since 2003. Foreclosures of older or more expensive homes rose by only 18 percent during the same period.
The failures are Charlotte's piece of a national problem.
Millions of lower-income families used easy-money loans to buy first homes over the past decade. Many put nothing down, paid no closing costs and received low introductory payments.
When the payments start climbing, many families can't keep up. Experts predict more than 1.5 million families who bought homes in recent years will lose those homes during the current wave.
Foreclosures are personal disasters, but it is increasingly clear that clusters of foreclosures damage entire neighborhoods. Home prices drop. Remaining owners can't afford to sell their homes for less than they paid. Additional foreclosures result. Renters move in. Crime can rise.

In Mecklenburg, the problems are concentrated in neighborhoods of vinyl-sided houses built in the past decade and priced below $150,000.

The Observer identified at least 35 starter-home developments in the county where 20 percent or more of the homes have foreclosed. That is more than six times the national foreclosure rate.

The troubled neighborhoods are concentrated west, north and east of downtown Charlotte, a crescent of deteriorating development that is putting pressure on surrounding communities.

"This is an issue we're going to have to address," says Charlotte City Council member Michael Barnes, whose district in northeast Charlotte contains more than a dozen high-foreclosure neighborhoods.

"Builders put them in, sell them and move on to another subdivision," Barnes says. "But we're all going to have to deal with the long-term repercussions ... including increased costs for public safety."

Two kinds of loans

More than 8,700 homes have foreclosed in Mecklenburg County since 2003. The county's foreclosure rate is the highest in the state.

Two kinds of home purchase loans are associated with most of the problems, according to an Observer analysis of foreclosures in 2003 and 2004. Subprime loans accounted for at least 24 percent of Mecklenburg foreclosures. Government-insured loans accounted for almost 30 percent.

The same companies often arrange both kinds of loans. They work with homebuyers who don't get loans from conventional sources such as banks. Some of those people have bad credit, others have little savings or income, some simply don't know they could get a better deal somewhere else.

The subprime industry grew up in the mid-1990s. The companies charge high interest rates, but impose few restrictions on eligibility. Most of the loans are sold through independent mortgage brokers.

Investors provided the money for the subprime industry. They profited handsomely from borrowers' payments. But as defaults rise, concern about those investments has driven down the stock market. Five of the largest subprime lenders have fired almost 6,000 people in the past year, including 250 employees of Wells Fargo & Co. in Fort Mill, S.C.

New Century Financial, the second-largest subprime lender, is on the verge of filing for bankruptcy.

Government-insured loans are also funded by investors, but the federal government promises to pay if the borrower doesn't. This encourages lending to lower-income families, but it leaves companies with little reason to exercise caution. In many cases, lenders made larger loans than borrowers could afford.

In Southern Chase, the Cabarrus County neighborhood profiled by the Observer on Sunday, the Federal Housing Administration already has spent $5 million to compensate lenders, some of it for loans that didn't meet government requirements in the first place.

Experts say the number of foreclosures in Mecklenburg and nationwide is likely to increase again this year as monthly mortgage payments continue to rise.

Year FCs StFCs Share
2003 1,692 357 21 %
2004 2,320 674 29 %
2005 2,233 670 30 %
2006 2,487 911 37 %
TOTAL 8,732 2,612 30 %

One builder, hundreds of foreclosures- 10 Beazer developments in Mecklenburg riddled by foreclosures

BINYAMIN APPELBAUM, LISA HAMMERSLY MUNN & TED MELLNIK
Staff Writers

In the past decade, Beazer Homes USA built more houses in Mecklenburg County that have since foreclosed than any other builder.

Beazer built about 2,900 homes in Mecklenburg between 1997 and 2006. At least 388 have foreclosed. That is a rate above 13 percent, the highest among the county's 10 most prolific builders during that period, an Observer investigation found.

Nationwide, less than 3 percent of buyers lose homes to foreclosure.

The Beazer foreclosures are concentrated in 10 developments, each of which has a foreclosure rate of 20 percent or higher. Together they contain about 1,150 homes and at least 280 foreclosures.

The neighborhoods sit in a crescent stretching from southwest Mecklenburg through north Charlotte to the county's eastern edge. The same area contains most of Mecklenburg's foreclosures.

All were built in a similar style: Small lots holding small vinyl-sided houses set on concrete slabs. They were marketed mostly to first-time home buyers. Prices started below $100,000 and usually topped out just above $150,000.

Two other similarities have produced the high foreclosure rates: Some buyers received larger loans than they could afford, and home prices generally stayed flat or declined. People who couldn't pay their loans and couldn't sell their homes fell into foreclosure.

Foreclosures are personal disasters, but it is increasingly clear that clusters of foreclosures damage entire neighborhoods. Home prices drop. Additional foreclosures result. Renters move in. Crime can rise.

"It was a disaster," says Veronica Wilkes, who bought a house from Beazer in 2001 in the northwest Charlotte subdivision of Brookmere.

Beazer built 31 homes on her street. Thirteen have foreclosed.

"There was trash all over the streets, kids walking through your yard," says Wilkes, who now rents out her home because she can't sell it. "You could tell the homeowners -- their yards were nice and pretty, and the other yards were terrible."

A story in Sunday's Observer charted the impact of foreclosures on Southern Chase, a Cabarrus County neighborhood where Beazer built 406 homes. Seventy-seven of the homes have foreclosed, a rate of 19 percent.

In a written statement, Atlanta-based Beazer originally said the foreclosure rate in Southern Chase was an anomaly.

When the Observer presented its findings about the 10 Mecklenburg developments with higher foreclosure rates, Beazer referred to its earlier statement. The company said its developments were marketed to first-time buyers, who tend to foreclose more often.

Beazer also said that it "is committed to providing quality homes of superior value and providing each and every homeowner with an enjoyable customer experience."

The company's CEO, Ian McCarthy, declined to speak with the Observer.

Government-insured loans

Beazer's troubled developments were backed by a silent partner: the federal government.More than 70 percent of the buyers in the 10 developments used loans insured by the Federal Housing Administration. The FHA encourages mortgage lending to lower-income families by promising to pay the lender if the borrower does not.

In one of the developments, Back Creek Hollow in northeast Mecklenburg, 64 of 70 buyers used FHA-insured loans. Seventeen of those homes have since foreclosed, a rate of more than one in four.

The largest source of FHA loans in the Beazer developments was Beazer itself.

A subsidiary called Beazer Mortgage acted as a broker, matching buyers with lenders for a fee of several thousand dollars on each loan.

The FHA loans that Beazer Mortgage arranged often were aggressive. The company provided down payments for most of its borrowers, leaving them with little stake in the homes. It also arranged loans with monthly payments that started low but rose sharply after the first and second years, a feature known as a buydown.

Both down-payment gifts and buydowns were associated with a higher risk of foreclosure, the Observer found.

Beazer and Eastwood Homes built on the same streets in Steelecroft Place, a subdivision in southwest Charlotte. Eastwood built slightly more than half the subdivision's 360 homes; Beazer built the rest. The houses are intermixed, sometimes on alternating lots.

Twenty percent of the Beazer homes have foreclosed, compared with 8 percent of the Eastwood homes.

The prices were similar. The Beazer homes have an average tax value of $138,000; the Eastwood homes, an average of $147,000.

The financing was different. Two-thirds of Beazer's buyers used FHA loans with low introductory payments that increased after the first and second years. About 5 percent of Eastwood's buyers used that kind of FHA buydown loan.

In a written statement, Beazer said that it followed all laws and regulations and that offering financial assistance to first-time buyers was a common industry practice.

The company also emphasized that it acts solely as a mortgage broker and that loans are ultimately approved or rejected by the lender. The company said buyers are informed of loan terms and sign documents at the closing table to indicate their understanding and acceptance.

Low cost, big problems

The county's foreclosure problems are concentrated in new neighborhoods with the lowest prices.

Derhyl Pruitt, a local real estate agent, said he tells first-time buyers, "If you can possibly stretch to pay $180,000, that will eliminate the problems."

Beazer itself built some developments in slightly higher price ranges. Those homes are relatively untouched by foreclosures.

In Beazer's 13 developments with average tax values above $150,000, less than 5 percent of homes have foreclosed.

In the 20 developments with average tax values below $150,000, almost 18 percent of homes have foreclosed.

The Beazer development with the highest foreclosure rate was in the Avensong subdivision, in eastern Mecklenburg County.

Beazer built 155 homes in a section called Stewarts Crossing between 1999 and 2001. Fifty-two of those homes have foreclosed.

Avensong also contains a section of about 160 houses built by Colony Homes and sold at higher prices. Twelve of those homes have foreclosed.

Karen and Loren Pittman have watched with alarm as one-third of their neighbors fell into foreclosure.

The Pittmans moved to Stewarts Crossing in May 2000. They paid $119,500 for a house with three bedrooms and 1,295 square feet.

They wanted a low-priced home so Karen could quit work and raise their children.

The next year, the county cut the tax value of the house by 11 percent to $106,100.

The couple have watched renters move in. Karen worries about her safety and doesn't walk on some streets. Tax values are rising now, but the Pittmans aren't sure that will carry over to sales prices.

"I would never buy into a neighborhood like this one again," she said. "We had no idea anything like this could happen."

Failed mortgages fly under the radar- From feds on down, no one keeps close track of foreclosures, limiting oversight

BINYAMIN APPELBAUM, LISA HAMMERSLY MUNN & TED MELLNIK
Staff Writers

The city of Charlotte does not count foreclosures. Neither does Mecklenburg County. Nor the state of North Carolina. Nor the federal government.

As a result, authorities did not notice an emerging pattern: Foreclosures increasingly were concentrating in starter home neighborhoods.

An Observer analysis of county records found 35 Mecklenburg developments of low-priced homes built in the past decade with foreclosure rates of 20 percent or higher. Dozens of residents say the concentrations have damaged their communities. Prices fell. Renters moved in. Crime sometimes rose.

But as the foreclosures piled up, authorities were unaware.

"We wouldn't know it on a neighborhood level," says Mark Pearce, deputy N.C. commissioner of banks, which regulates loan sellers. "A 20 percent foreclosure rate in a neighborhood that's new is surprising and troubling."

Even the Federal Housing Administration, which insured many of the failed loans, didn't track the concentrations.

The Observer on Sunday profiled Southern Chase, a neighborhood of 406 houses in Concord built by Beazer Homes USA. Seventy-seven buyers lost their homes to foreclosure. Forty-five of the failed loans were insured by the FHA. But federal officials expressed surprise when asked about the concentration.

The Department of Housing and Urban Development, which administers the FHA program, was unable at first to say how many loans it insured on streets in Southern Chase. It was unable to say which ones had foreclosed. And it didn't know all the failed loans were in one neighborhood.

The lack of information about the location of foreclosures makes it harder to regulate the lending industry. Buyers share responsibility for the loans they accept, and foreclosures sometimes result from the loss of a job or an unexpected expense. But regulators say that concentrations of foreclosures often indicate misconduct by someone else, such as a broker who arranged a number of loans or an appraiser who valued the homes.

None of the government agencies contacted by the Observer plans to start tracking foreclosures.

Federal authorities

About 8,700 homes have foreclosed in Mecklenburg County over the past four years. The county's foreclosure rate is the highest in the state.An Observer study found almost 30 percent of the foreclosures in 2003 and 2004 were associated with loans insured by the federal government.

The FHA encourages lending to lower-income families by promising to repay lenders if the borrower does not. The money comes from premiums paid by borrowers, not from taxpayers.

In the mid-1990s, the FHA started insuring riskier loans. Borrowers were no longer required to make a down payment. Lenders could arrange larger loans simply by projecting that a borrower's income was likely to increase.

The share of Americans who own homes rose to almost 69 percent last year from 65 percent in 1996. The FHA was responsible for a share of the increase. So were subprime lenders, which make loans with high interest rates to the same people traditionally served by the FHA.

But now the number of foreclosures also is pushing into record territory, driven by defaults on FHA and subprime loans, according to estimates made by the lending industry.

"The mortgage industry has said they have increased home ownership," HUD's inspector general, Kenneth Donohue, told a U.S. House committee last week. "However, at what cost to the American people?"

The FHA has tightened some of its standards in response to the problems.

In 2004, it stopped allowing lenders to increase the size of a loan by projecting a borrower's income would increase.

Beazer arranged such loans for 147 buyers in Southern Chase. More than a quarter ended in foreclosure, often because the borrower's income did not increase.

But the FHA continues to allow buyers to purchase homes with no money down. It requires a 3 percent down payment, but it allows sellers to provide the money to the buyer indirectly. Federal studies show the price of the home is often increased to cover the expense. That leaves buyers with no equity.

Government reports have criticized the practice because borrowers foreclose more often if they don't own a stake in the home. In Southern Chase, Beazer provided down payments for 135 borrowers. More than a quarter have foreclosed.

State authorities

The newspaper found that Beazer, which arranged loans for most buyers in Southern Chase, in some cases arranged larger loans than buyers could afford. Facts were misstated on an appraisal obtained by the Observer.

North Carolina's regulatory boards license mortgage brokers and lenders, appraisers and other real estate professionals. They can revoke licenses and refer cases to law enforcement.

But regulators lack basic information about who is involved in the lending process. The name of the lender appears in public records, but not the name of the appraiser, or the broker that arranged a loan.

The N.C. Appraisal Board usually investigates only after receiving a complaint. That means it often relies on homeowners to figure out the price of their home may have been inflated -- and which state agency to call.

The N.C. Commissioner of Banks is prioritizing examinations of mortgage brokers whose loans result in a large number of foreclosures, deputy commissioner Pearce said. But Pearce said the agency continues to rely mostly on complaints from the public to know which brokers deserve scrutiny.

After the Observer first reported last year on Mecklenburg County's spiking foreclosure rate, state legislators filed a bill to include appraisers and mortgage brokers in the public record. It died in committee.

Some legislators haven't believed foreclosures are a problem, says Rep. Becky Carney, D-Mecklenburg, a vice chair of the House committee created to study foreclosures after the Observer's stories last year.

There's more attention on the issue now, Carney says, because of the problems in the subprime lending industry.

Some legislators, she says, "are as surprised now as some of us were last year."

Local authorities

New subdivisions require approval from city and county government, as do the land-use plans that determine where subdivisions can be built.

About 24,000 starter homes with tax values below $150,000 were built in Mecklenburg County between 1997 and 2005, according to property records. That's about 40 percent of all new homes in the county during that period.

The starter-home developments were concentrated in a crescent that stretches from southwest of downtown, through northern Charlotte, to the eastern county limits.

Because the starter-home developments sit close together, that is now the crescent in which Mecklenburg's foreclosures increasingly are concentrated, too.

City officials want to provide affordable housing to lower-income residents, says Richard Woodcock, Charlotte's deputy director of neighborhood development.

"But we don't want the foreclosures," he says.

The starter home developments share a style: Small lots holding small vinyl-sided houses set on concrete slabs. Some have no sidewalks. Common spaces are uncommon.

City and county boards can require builders to make their subdivisions more desirable, by providing sidewalks, open space and varied home facades.

The city of Concord upgraded its subdivision standards in 2000, partially in response to problems in Southern Chase, said City Manager Brian Hiatt. Charlotte also has adopted rules requiring sidewalks and other amenities.

Finally, local governments can provide help to homeowners facing foreclosure.

Chicago eut foreclosures by 10 percent after it started arranging counseling for owners who called the city.

The Charlotte City Council rejected a request last year for increased funding from the nonprofit that provides foreclosure prevention counseling to city residents. The issue is expected to come up again this year.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 24, 2007

The Honorable Brad Miller
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Miller:

Thank you for the opportunity to present the views of the Office of the Comptroller of the Currency at the hearing entitled" Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Financial Institutions."

During the hearing, you asked me to provide data on subprime loan defaults. My staff was able to locate data on mortgage delinquency and foreclosure trends for both prime and subprime loans from the Loan Performance Corporation. The data are summarized in the enclosed graphs.

I hope this information is helpful to you. Please do not hesitate to contact me if you have any further questions.

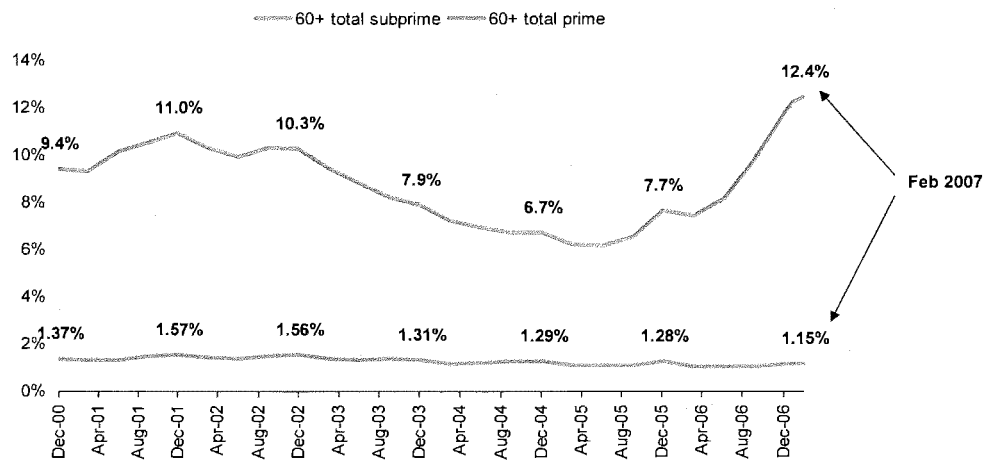
Sincerely,

Emory W. Rushton
Senior Deputy Comptroller

Enclosure

Mortgage Delinquency Trends

Prime and Subprime -- % 60+ days past due

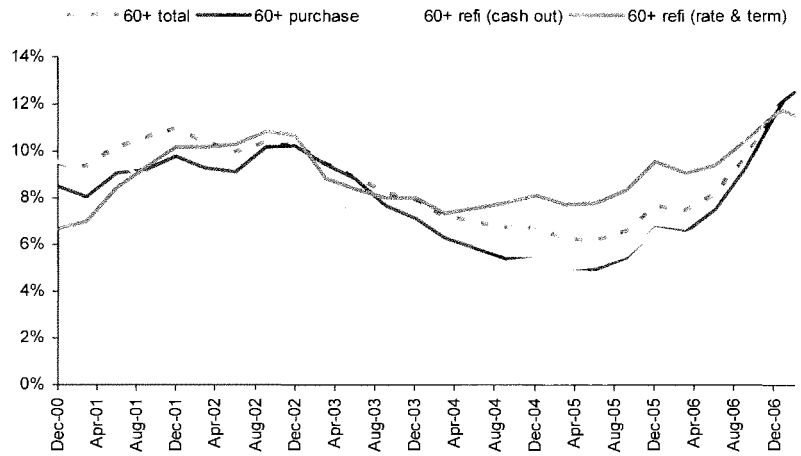


- *The charts in this deck show delinquency and foreclosure trends for prime and subprime mortgage loans. The data is on a quarterly basis from December 2000 through December 2006, and monthly for January and February 2007.*
- *The data source is Loan Performance Corp. They estimate their database has approximately 60% of the market, so this is likely the best proxy for market activity.*
- *In the charts that follow, both delinquencies and loans in foreclosure are segmented by: (1) total performance (for either prime or subprime loans), (2) loans used to purchase a home, (3) loans used to refinance with cash given to the borrower as part of the transaction, and (4) loans used to refinance for rate and term purposes only (no cash to the borrower). Of note, part of the original request was for information that segments first-time purchases in the purchase-loan data. We do not have that level of segmentation.*

Source: Loan Performance Corp. (May 2007)

Subprime Delinquency Trends

Subprime Delinquency -- % 60+ days past due

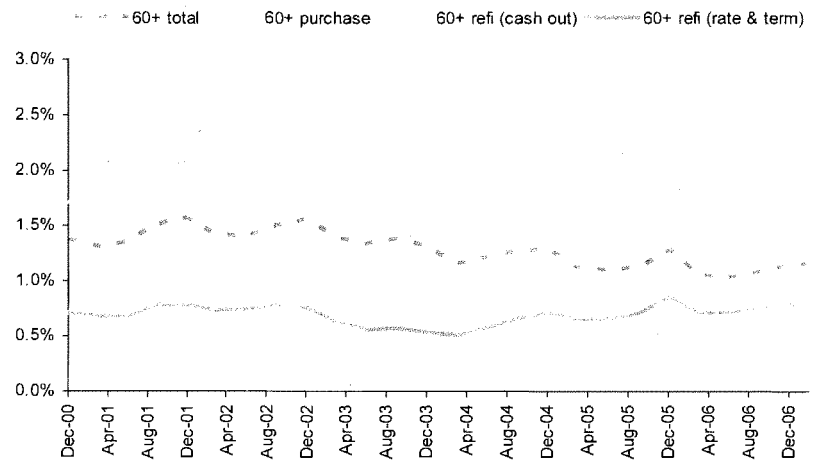


	Dec-00	Dec-01	Dec-02	Dec-03	Dec-03	Dec-05	Dec-06	Feb-07
Subprime 60+ delinquent -- purchase	8.50%	9.80%	10.20%	7.12%	5.40%	6.75%	11.62%	12.50%
Subprime 60+ delinquent -- refi (cash out)	9.57%	8.67%	8.26%	6.09%	5.40%	6.69%	10.23%	10.67%
Subprime 60+ delinquent -- refi (rate & term)	6.66%	10.14%	10.66%	8.01%	8.13%	9.57%	11.62%	11.51%
Subprime 60+ delinquent -- total	9.43%	10.95%	10.30%	7.91%	6.73%	7.69%	11.79%	12.44%

Source: Loan Performance Corp. (May 2007)

Prime Delinquency Trends

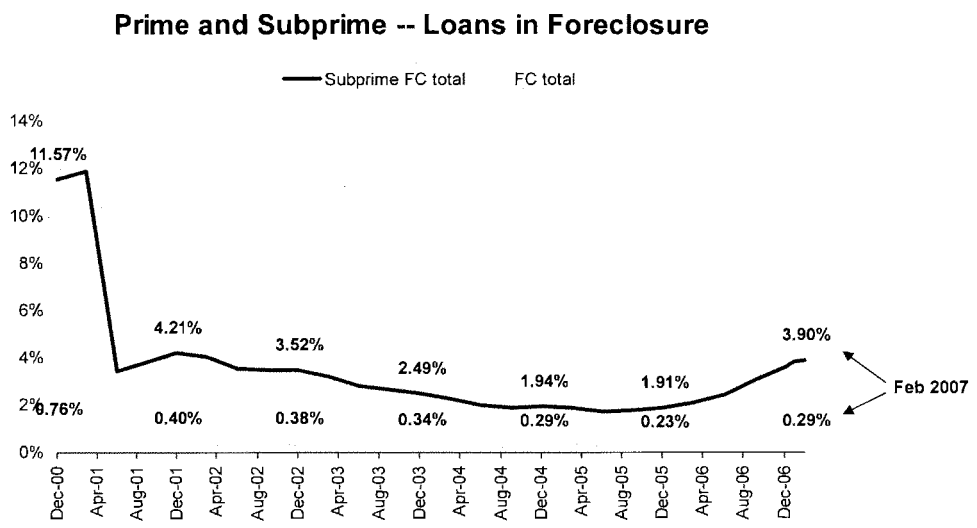
Prime Delinquency -- % 60+ days past due



	Dec-00	Dec-01	Dec-02	Dec-03	Dec-03	Dec-05	Dec-06	Feb-07
Prime 60+ delinquent -- purchase	1.71%	2.10%	2.36%	2.69%	2.29%	1.98%	1.60%	1.58%
Prime 60+ delinquent -- refi (cash out)	0.70%	0.79%	0.73%	0.58%	0.65%	0.72%	0.78%	0.82%
Prime 60+ delinquent -- refi (rate & term)	0.71%	0.79%	0.76%	0.54%	0.72%	0.86%	0.79%	0.79%
Prime 60+ delinquent -- total	1.37%	1.57%	1.56%	1.31%	1.29%	1.28%	1.14%	1.15%

Source: Loan Performance Corp. (May 2007)

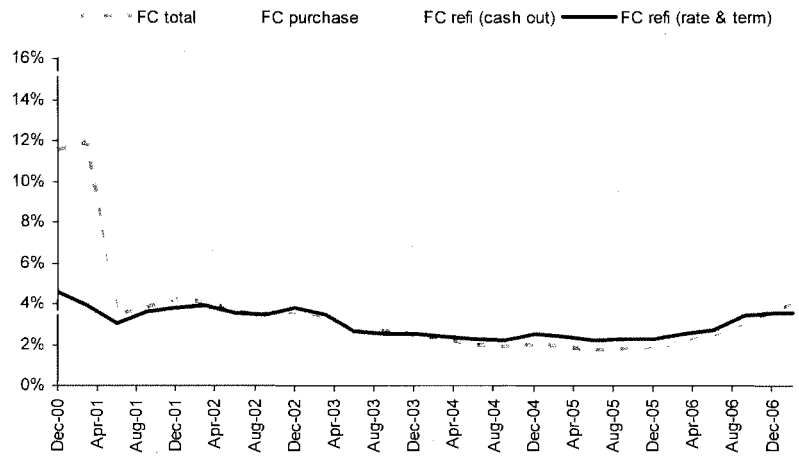
Foreclosure Trends



Source: Loan Performance Corp. (May 2007)

Subprime Foreclosure Trends

Subprime -- Loans in Foreclosure

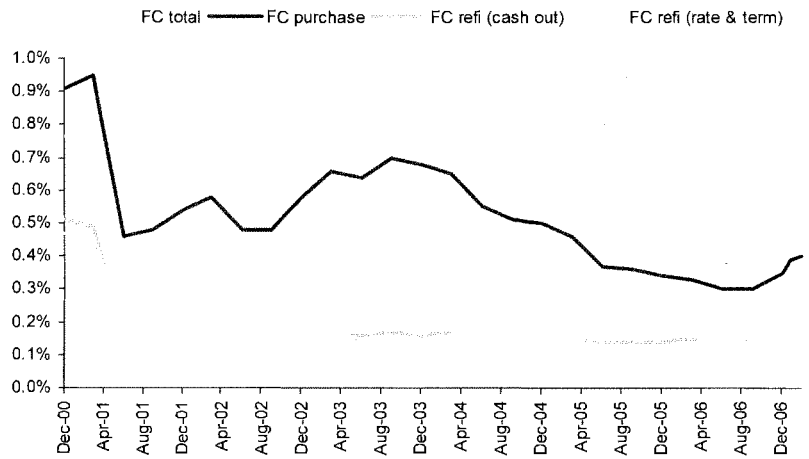


	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Feb-07
Subprime foreclosure -- purchase	15.22%	3.86%	3.45%	2.31%	1.71%	2.01%	3.96%	4.33%
Subprime foreclosure -- refi (cash out)	3.57%	3.61%	2.97%	2.04%	1.65%	1.58%	3.28%	3.41%
Subprime foreclosure -- refi (rate & term)	4.59%	3.78%	3.84%	2.54%	2.53%	2.26%	3.53%	3.54%
Subprime foreclosure -- total	11.57%	4.21%	3.52%	2.49%	1.94%	1.91%	3.63%	3.90%

Source: Loan Performance Corp. (May 2007)

Prime Foreclosure Trends

Prime -- Loans in Foreclosure



	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Feb-07
Prime foreclosure -- purchase	0.91%	0.54%	0.58%	0.68%	0.50%	0.34%	0.35%	0.40%
Prime foreclosure -- refi (cash out)	0.51%	0.19%	0.18%	0.16%	0.16%	0.14%	0.20%	0.22%
Prime foreclosure -- refi (rate & term)	0.47%	0.19%	0.17%	0.14%	0.17%	0.16%	0.19%	0.20%
Prime Foreclosure -- total	0.76%	0.40%	0.38%	0.34%	0.29%	0.23%	0.26%	0.29%

Source: Loan Performance Corp. (May 2007)

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

SHEILA C. BAIR
CHAIRMAN

May 7, 2007

Honorable Tom Price
House of Representatives
Washington, D.C. 20515

Dear Congressman Price:

Thank you for your questions subsequent to my testimony before the Subcommittee on Financial Institutions and Consumer Credit on March 27 regarding Subprime and Predatory Mortgage Lending.

Enclosed are my responses to those questions. If we can provide further information, please let us know.

Sincerely,

Sheila C. Bair

Sheila C. Bair

Enclosure

cc: Honorable Carolyn B. Maloney

Responses to Questions from Congressman Tom Price
Hearing on Subprime and Predatory Lending

Q1: Are we facing a problem that is large in scope or a market correction?

A1: Although the current difficulties in subprime mortgages affect large numbers of borrowers, these problems represent a relatively small portion of the overall mortgage market. Almost three-quarters of securitized subprime mortgages originated in 2004 and 2005 were "2/28" and "3/27"[1] hybrid loan structures.[2] Most of these borrowers are having difficulty making the payments on these loans after the "reset" to higher payments – often an increase of thirty percent or more – that occurs after the initial two or three years of loan payments. According to one study, the interest rates for an estimated 1.1 million subprime loans, with a balance of $197 billion, will reset in 2007 and an additional 882,000 loans, with a balance of $179 billion, will reset in 2008. Fewer and fewer of these borrowers are able to refinance because of the slowing rate of home price appreciation, higher interest rates and the problems faced by subprime lenders.[3] However, taken in context, the approximate total of $376 billion in loans that will reset in 2007 and 2008 represents only about three percent of the $10.2 trillion total outstanding balance of all mortgages as of year-end 2006.[4]

Q2: What caused these problems in the subprime mortgage market?

A2: A number of factors, including intense lender competition, historically low interest rates, rapid home price appreciation, and investor demand for mortgage paper, facilitated the dramatic growth in the subprime market between 2003 and 2005. After many prime borrowers obtained loans during the refinance boom of 2003, mortgage originators struggled to maintain or increase market share in the declining origination market. Many of these lenders operated large origination platforms that needed mortgage paper to remain viable. Borrowers with blemished credit histories, many of whom were not able to obtain financing during the refinance boom, began to represent a larger portion of potential customers. As a result, the subprime share of all mortgage loan originations jumped from 7.9 percent in 2003 to 20 percent in 2005.[5] As of third quarter 2006, subprime mortgages accounted for approximately 12.8 percent of all mortgage debt

[1] 2/28s and 3/27s are hybrid ARMs typically marketed to subprime borrowers. These ARMs are similar to ARMs that are prevalent in the prime market (known as 3/1 ARMs), in that they have a fixed rate for 2/3 years and then adjust to a variable rate for the remaining 28/27 years. However, the spread between the initial fixed rate of interest and the fully-indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points on 2/28 and 3/27s, versus 100-250 basis points on prime 3/1 ARMs.
[2] Source: LoanPerformance database of nonprime (subprime and Alt-A), non-agency securitized mortgage originations.
[3] Christopher L. Cagan, "Mortgage Payment Reset: The Issue and the Impact," First American CoreLogic, March 19, 2007, http://www.firstamres.com/MPR2007.
[4] Christopher L. Cagan, "Mortgage Payment Reset: The Issue and the Impact," and Federal Reserve Flow of Funds.
[5] *Inside Mortgage Finance*, December 1, 2006.

outstanding.[6] As competitive pressures and investor appetite for more volume increased in the mortgage market, many lenders loosened their underwriting standards. Many products originated in more recent periods required little or no documentation of income or were accompanied by practices such as simultaneous second-lien mortgages that create additional layers of risk for lenders. The loosened underwriting standards are reflected in loan performance. Subprime mortgage loans originated in 2006 are becoming seriously delinquent much sooner than similar loans originated in prior years.

Many subprime borrowers have benefited from the expansion of mortgage credit. However, rather than building wealth, many other borrowers are struggling to keep their homes. Many subprime borrowers have little financial cushion in the event of personal emergencies or economic downturns. In addition, many subprime borrowers have been the targets of practices that are highly troubling, if not predatory. Repeat refinancings have taken equity from borrowers' homes and adjustable rate features have challenged borrowers' ability to continue making payments. In previous years, many of these borrowers could have refinanced their mortgages or sold their homes at a profit to repay their debt in full. Now, as home prices have stagnated or even declined in many areas of the country, more borrowers find themselves unable to refinance or to repay at higher reset rates.

Q3: How is the market responding and what effect is it having?

A3: Many lenders, loan servicers, and other participants in the mortgage market are currently working with stressed borrowers. They are seeking ways to restructure loans or find other ways to allow borrowers to keep their homes and make more affordable payments. However, the growth of securitization in the subprime mortgage market has complicated the ability of interested parties to apply flexibility and creativity to assist borrowers facing difficulty.

In addition, the mortgage marketplace is continuing to change. The hybrid ARM products are not used as often as in recent years. The 2/28 and 3/27 products accounted for 23 percent of total private-label originations during 2006, down substantially from these products' market share in 2005 (38 percent) and in 2004 (43 percent).

Many analysts have written about the declining liquidity in the subprime market, which is demonstrated by the increasing cost to insure against defaults of subprime loans. We believe that market forces are having an impact on originations of subprime hybrid loans. However, it is difficult to make a direct connection between the liquidity trends and specific products. A reduction in liquidity for the 2/28 and 3/27 loans is one explanation for the decline in volumes for these products, but the shift in product originations could also be explained by lenders choosing to modify underwriting standards and product mix or by changes in consumer demand.

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[6] FDIC-derived estimate based on third quarter 2006 data from *Mortgage Market Update* and the Federal Reserve Board's Flow of Funds data.

Freddie Mac recently announced that it will purchase 2/28 loans and related mortgage securities backed by them only if borrowers are qualified at the fully-indexed and fully-amortizing rate. Also, Freddie Mac and Fannie Mae both recently announced that they are instituting programs that will provide alternative financing for borrowers with impaired credit. In addition, several large financial institutions have announced new initiatives to provide refinancing options for troubled borrowers. The mortgage market is continuing to evolve through introduction of new products. It is too early to gauge the results of lenders' and servicers' workouts with distressed borrowers, or the effects of new product offerings.

Q4: What, if any, is the appropriate role for Congress, or is it too late because the market has already started adjusting?

A4: Federal bank regulators have promulgated guidelines and other supervisory standards for mortgage lending, but these apply to only a portion of the market. Given the level of credit distress in the subprime mortgage market, with especially pronounced problems among independent mortgage lenders, there is a need for a comprehensive response that assures that all lenders are subject to certain baseline requirements. Moreover, the current lack of uniform standards creates negative competitive pressures on FDIC-insured institutions. A national anti-predatory lending standard would help assure basic uniform protections for all borrowers, as well as create a more level competitive playing field for all mortgage lenders.

Congress could articulate a set of anti-predatory lending standards in a statute that, at its core, addresses at least two important areas: 1) the ability of the borrower to repay the loan and 2) misleading marketing and disclosures that prevent borrowers from fully understanding the terms of loan products.

In drafting national standards, Congress should draw from the experience of states, which have proven to be innovative laboratories for the development of consumer protections in recent years, especially in the area of predatory lending.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SANDRA F. BRAUNSTEIN
DIRECTOR
DIVISION OF CONSUMER
AND COMMUNITY AFFAIRS

May 29, 2007

The Honorable Tom Price
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my responses to your additional questions following the March 27 hearing before the House Subcommittee on Financial Institutions and Consumer Credit. I have also forwarded a copy to the Committee on Financial Services for inclusion in the hearing record.

Sincerely,

Enclosure

Sandra Braunstein subsequently submitted the following in response to written questions received from Congressman Tom Price in connection with the March 27, 2007, hearing before the Subcommittee on Financial Institutions and Consumer Credit:

1. Are we facing a problem that is large in scope or a market correction?

According to data from the Mortgage Bankers Association's National Delinquency Survey, the share of subprime loans in foreclosure has increased steadily since mid-2005. Between June 2005 and December 2006, the foreclosure inventory for all subprime loans rose from 3.29 to 4.53 percent, an increase of 1.24 percentage points. This increase in the foreclosure inventory for subprime loans over the past year and a half has been driven primarily by an increase in the inventory of subprime adjustable rate mortgages (ARM) in foreclosure. Over this same time period, the share of subprime ARM loans in foreclosure rose from 3.16 to 5.62 percent, a 2.46 percentage point increase, while the foreclosure inventory for subprime fixed rate mortgages actually fell slightly, from 3.24 to 3.19 percent. To put these data in context, about 1 in 7 mortgages is to a subprime borrower. Fewer than 1 in 10 of subprime borrowers have a subprime ARM.

Although there are some indications that the market is correcting itself, we remain concerned that over the next one to two years, existing subprime borrowers, especially those with more recently originated ARMs, may face further difficulties. They are likely to continue to experience elevated delinquency and foreclosure rates as these loans reach their interest rate reset point and they are faced with larger monthly payments. The Board is justifiably concerned about the impact of foreclosures on borrowers and communities, and will continue the efforts outlined in my testimony to assist borrowers.

2. What caused these problems in the subprime mortgage market?

Subprime foreclosures hit multi-year lows in the middle of 2005 against a backdrop of historically low interest rates and rapid price gains. As these factors have unwound, we would naturally expect some increase in defaults. In particular, with house prices flat or even falling in some markets, the most recent subprime borrowers may be especially vulnerable because they have the slimmest equity cushions.

The rise in foreclosures may also be due in part to laxer underwriting standards in 2006. Loans originated in 2006 have seen a sharp rise in the number of "early payment defaults"--loans that default shortly after origination. While some borrowers will default shortly after they take out a loan because of job loss or other unexpected events, it is not clear that these events became more frequent last year. This suggests that some lenders may have lowered their underwriting standards in the face of reduced borrower demand for credit. Several lenders have already been forced out of the subprime market, in part because of the wave of early payment defaults on mortgages they originated.

Because of the rapid expansion of subprime lending in recent years, lenders, investors, and ratings agencies had limited data with which to model credit risk posed by new borrowers or novel mortgage types, and so may have underestimated the risk involved.

3. How is the market responding and what effect is it having?

We see some signs that the mortgage market is responding in ways that we expect will mitigate future problems. Investors seem to be scrutinizing subprime loans more carefully, and because of this, lenders are tightening underwriting standards and are now less willing to make loans that contain substantial risk layering. As would be expected, interest rates have increased on new subprime mortgage originations, and the volume of mortgage-backed securities issuance indicates that subprime originations are down. Yet, the supply of credit has not evaporated. Purchases of securitized subprime mortgages for collateralized debt obligations--a traditional source of demand--have dropped off as purchasers review the effects of higher-than-expected loan losses on their financial positions, but increased purchases by hedge funds are beginning to fill the void. Some subprime originators have gone out of business as securitizers have pulled credit lines, but others have been purchased by investment banks. Furthermore, we see no broader spillover to banks and thrift institutions; the troubled lenders, for the most part, have not been depository institutions.

4. What, if any, is the appropriate role for Congress, or is it too late because the market already started adjusting?

As stated, we believe the market appears to be correcting, however, many subprime borrowers are already facing potential foreclosure actions. The Board and the other supervisory agencies have encouraged financial institutions to identify and contact borrowers who, with counseling and financial assistance, may be able to avoid entering delinquency or foreclosure. Several states and private entities have undertaken measures designed to help lower income borrowers facing foreclosure. And, as I outlined in my testimony, the Federal Reserve System's Community Affairs Offices have initiatives underway to increase understanding of the issues surrounding troubled borrowers and identify strategies to respond to their needs.

In addition, although correction has begun, the Board is considering whether there are actions that could address concerns about underwriting and consumer protection in the subprime market. In March 2007, the Board and the other federal financial supervisors issued a proposed statement on subprime mortgage lending that would emphasize the need for prudent underwriting and clear communications with consumers about adjustable rate mortgages targeted to subprime borrowers. The period for the public to submit comments ended on May 7, 2007; the agencies are currently analyzing the comment letters. And, as I stated in my testimony, the Board is considering how it might use its rulemaking authority to

address concerns about abusive lending practices in the subprime market. On June 14, 2007, the Board will hold a public hearing to gather information on these issues. The Board believes the rise in subprime foreclosures needs to be addressed in a way that preserves incentives for responsible subprime lenders so that borrowers with non-prime credit can become homeowners, access the equity in their homes, or have flexibility in refinancing their mortgages when necessary.

May 7, 2007

Representative Tom Price
424 Cannon House Office Building
Washington, D.C. 20515-1006

Dear Representative Price:

On March 27th of this year, I testified at the Subcommittee on Financial Institutions and Consumer Credit hearing entitled "Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Financial Institutions." Thereafter, I received four questions from your office, and I am attaching the answers to those questions hereto.

Thank you for the opportunity to be a part of the solution to the foreclosure crisis seen in today's subprime market. I am certain that we all want the same result: effective reforms to address this crisis and preserve homeownership.

I look forward to continuing our discussions.

Sincerely,

Mike Calhoun
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Committee on Financial Services
Hearing on the Subprime and Predatory Lending
Subcommittee on Financial Institutions and Consumer Credit
Office of Congressman Tom Price
March 27, 2007

Are we facing a problem that is large in scope or a market correction?

What caused these problems in the subprime mortgage market?

How is the market responding and what effect is it having?

What, if any, is the appropriate role for Congress, or is it too late because has the market already started adjusting?

Are We Facing A Problem That Is Large In Scope Or A Market Correction?

Although there has been a correction in housing prices with the cooling of the housing market, the foreclosure crisis we face is far more than a market correction. Despite low interest rates, rising housing appreciation rates and a favorable economic environment during the past several years, the subprime market is experiencing high foreclosure rates comparable to the worst foreclosure experience ever in the modern mortgage market. The recent flattening of housing appreciation has served to illuminate deep-seated problems within the subprime industry, including push marketing, lax underwriting, and a lack of accountability for abusive or inappropriate loans.

We project that in the current crisis 2.2 million borrowers either have lost or will lose their homes and up to $164 billion of family wealth will be lost in the process.[1] Market corrections will not salvage the homes of those who are already in bad loans, and the number of families who have lost or will lose their homes is nearly *1 million more* than the number of new homeowners created through subprime mortgage lending over the same period.[2] Instead, as subprime mortgages foreclose and families lose their homes, their surrounding neighbors' home values will also decline. Each neighborhood foreclosure may have a cumulative negative impact on the value of other neighbors'

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[1] Ellen Schloemer, Wei Li, Keith Ernst and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* (Center for Responsible Lending, December, 2006), http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf ("*Losing Ground*") at 3.
[2] *Subprime Lending: A Net Drain on Homeownership*, CRL Issue Paper No. 14, Center for Responsible Lending, (March 27, 2007), available at: http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf

homes.[3] Foreclosures often leave vacant or abandoned properties that can contribute to physical disorder in a community, discourage the formation of social capital, and lead to further disinvestment. Additionally, foreclosures cost the holders of the loan an estimated average of $58,792 and take 18 months to resolve. Cities, counties, and school districts also lose as the tax base erodes.

These devastating losses demonstrate that the mortgage market cannot be relied upon to correct itself before the damage is done.

What Caused These Problems In The Subprime Mortgage Market?

Widespread abusive lending practices have contributed to the problems in the subprime market. The subprime mortgage market has been dominated by a perverse system of incentives that rewarded inappropriate and unsound lending practices, and made it more difficult for responsible lenders to compete. The market encouraged loan originators to push-market dangerous hybrid adjustable rate mortgages (ARMs) with large built-in payment shock, even when families qualified for sustainable fixed-rate loans at little or no cost increase. Subprime lenders routinely marketed the most dangerous loans to the most vulnerable families, and to families already struggling with debt. Compounding the payment shock issue, lenders often failed to escrow tax and insurance premiums, and engaged in unsound underwriting practices. In short, borrowers were often sold loans they could not afford by mortgage brokers and lenders with little financial interest in loan performance.

Meanwhile, over the past several years, Wall Street became enamored with subprime mortgages. Subprime-backed investments worked well for the market when

[3] Dan Immergluck and Geoff Smith, The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values, p. 57, 69, 72, 75 Housing Policy Debate (17:1) Fannie Mae Foundation (2006) at http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_immergluck.pdf.

homes appreciated rapidly, since the loan structure forced serial refinancings that occurred during this time that provided significant fee income to investment banks, ratings agencies, lenders and mortgage brokers. However, Wall Street's hunger for subprime volume continued in spite of widespread warnings about a slow-down in housing appreciation. To satisfy growth in the market, lenders loosened underwriting guidelines and developed more dangerous products, and Wall Street continued to accept these loans. With a flattening of appreciation rates or a decline in property values, hundreds of thousands of borrowers will lose their option to refinance or sell their house to escape the built-in 30% to 40% payment shock, and will therefore lose their homes to foreclosure. Many in the industry now admit that they put short-term growth goals ahead of long-term sustainability.[4]

How Is The Market Responding And What Effect Is It Having?

The market is making some corrections. Unfortunately, the market's reluctant response has been completely inadequate to deal with the crisis.[5] Furthermore, the response has done little to save the homes of those families who have already been victimized. Part of the problem is a lack of accountability and perverse market incentives that reward the industry for making unsustainable loans. Lenders have been able to pass

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[4] See, *e.g.* David Cho, "Pressure at Mortgage Firm Led to Mass Approval of Bad Loans", The Washington Post (May 7, 2007), available at: http://www.washingtonpost.com/wp-dyn/content/article/2007/05/06/AR2007050601402.html?hpid=topnews ("The head of a large Wall Street bank's mortgage group contended that his firm regularly lost out on New Century's business because its due diligence process was stringent and it had been returning a high number of loans. New Century wanted the bank to ease its standards, and the issue became a source of friction between the companies. 'The entire industry, over time, became more lax,.... The more [loans] you accepted, the better relationship and the better price you would have. The name of the game was definitely volume.'"); See also Jon Menon and Ben Livesey, HSBC boosts set-aside for bad loans, Chicago Sun-Times (February 9, 2007), (HSBC set aside $10.56 billion reserves; executive Brendan McDonah notes that HSBC "made the mistake of going for volume.")

[5] See, *e.g.* Jody Shenn, Countrywide's Mozilo Says Regulators May Worsen Subprime Losses, Bloomberg.com (April 23, 2007) (urging that troubled-loan refinances be exempted from these guidelines which, ironically, are designed to reduce the incidence of troubled loans.)

off a significant portion of the costs of foreclosure through risk-based pricing, which allows them to offset even high rates of predicted foreclosures by adding increased interest costs. Further, the ability to securitize mortgages and transfer credit risk to investors has significantly removed the risk of volatile upswings in foreclosures from lenders. In other words, high foreclosure rates have simply become a cost of business that is largely passed onto borrowers and sometimes investors.

Even today dangerous products remain a staple in the market despite the lessons of recent months. Subprime lenders continue to originate highly dangerous loans, and Wall Street continues to accept these loans. A review of five mortgage-backed securities offered in the first quarter of 2007 reveals that loans containing features shown to increase the risk of foreclosure – loans whose interest rates explode after two years, loans that do not document income, and loans that do not escrow for taxes and insurance -- remain in a large portion of subprime offerings.

What, If Any, Is The Appropriate Role For Congress, Or Is It Too Late Because The Market Has Already Started Adjusting?

It is not too late for Congress to act. If Congress takes swift action, hundreds of thousands of families could avoid foreclosure and stay in their homes. We offer the following six simple and effective policy solutions to help save families' homes, to stop destructive lending practices in the subprime market and to return to sound lending practices.

1. Restore safety to the subprime market with an "ability to repay" standard for all subprime loans. On March 8, 2007, federal banking and credit union regulators issued a proposed Statement that explicitly offers greater protections against the risks

posed by exploding ARMs. The Statement says that an institution's analysis of a subprime borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. It also discourages stated income loans and encourages lenders to escrow for taxes and insurance. We strongly urge the regulators to finalize these provisions as soon as possible, and believe that Congress should adopt a similar standard for all originators that includes a private right of action.

2. Require the Federal Reserve Board to act, or address abuses through the Federal Trade Commission. Current federal law—the Home Ownership and Equity Protection Act of 1994 (HOEPA)—governing predatory lending is inadequate and outdated. However, through HOEPA, Congress mandated that the Federal Reserve Board address mortgage lending abuses on all loans through regulation and gave it broad authority to carry out this responsibility. To date the Board has not used this authority. The Board must address abusive lending practices to prevent another foreclosure crisis in the future. The Board has announced a June 14 hearing on the issue. If it does not in a timely fashion adopt rules to address subprime mortgage abuses, Congress should give parallel authority to the Federal Trade Commission to address harmful practices that have gone on too long.

3. Hold all industry players accountable for their actions. Lenders, brokers, servicers, investors and trustees should stem the tide of foreclosures by proactively modifying loans to make them sustainable. To keep this crisis from reoccurring, Congress should require lenders to have greater accountability for brokers' actions, and brokers should have a fiduciary duty to serve the best interests of their clients. And when

investors purchase loans, Congress should ensure that they assume legal liability (called "assignee liability") for loans that are abusive or predatory.

4. Strengthen existing bankruptcy law to assist homeowners harmed by subprime foreclosures. Many struggling borrowers have no chance for recovery except through bankruptcy, but current bankruptcy law singles out the home mortgage loan as the one debt for which the bankruptcy court cannot provide relief. To assist homeowners who are trying to recover from exploding subprime loans, a change to the bankruptcy code to enable courts to modify home loans to make them sustainable, thereby putting a loan for a family's principal residence on par with loans for investment properties, second homes, family farms and boats, is necessary.

5. Help upside-down borrowers in foreclosure whose lenders forgive the debt to the market value of the home. In some cases, borrowers facing foreclosure are able to negotiate with their mortgage holder to forgive all or part of the mortgage balance that exceeds the fair market value to make the loan one that the borrower can afford to pay, in order to make sure that the investor can get paid. However, under current tax law, the amount forgiven is counted as taxable income to the homeowner, and taxed at ordinary rates. Congress should relieve families of this unfair tax burden where the lender forgives part of the mortgage so there will be no taxable event. The people who are most vulnerable to this mortgage forgiveness tax dilemma are those who can least afford to pay. As such, without some form of tax code relief, the write-down may not save a family's home.

6. Strengthen protections against destructive home lending by passing a strong national anti-predatory lending bill. HOEPA has not kept up with the

evolution of abuses in the market, and needs to be updated and strengthened. As HOEPA does today, any new federal law must preserve the right of the states to supplement the law, when necessary, to address new or locally-focused lending issues.

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Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 11, 2007

The Honorable Tom Price
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Price:

Thank you for the opportunity to present the views of the OCC at the hearing entitled "Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Financial Institutions." Enclosed are responses to the additional questions you sent to us to complete the hearing record.

I hope these responses are helpful. Please do not hesitate to contact me if you have any further questions.

Sincerely,

Emory W. Rushton
Senior Deputy Comptroller

1. Are we facing a problem that is large in scope or a market correction?

As noted in my written testimony, we are now confronting adverse conditions in the subprime mortgage market, including disturbing but not unpredictable increases in mortgage delinquencies and foreclosures. According to the Mortgage Bankers Association's (MBA) nationwide delinquency survey, approximately 14.4% of subprime adjustable-rate mortgages were 30-days or more delinquent at the end of 2006. This was the third consecutive year-end increase, and the highest December level since the 15.25% in 2000.

But though the subprime performance warrants attention, it's less clear whether problems will spread to the broader mortgage market. Subprime originations were 20% of total mortgage originations in both 2005 and 2006, a significant increase from the 8% as recently as 2003. Despite this growth, by the end of 2006 subprime loans were estimated to be no more than 10%-15% of the approximately $10.2 trillion of total mortgage debt outstanding. To view this in context, at the end of 2006 subprime loans accounted for approximately 10%-15% of the total outstanding mortgages, Alt-A mortgage products for another 10-15%, with the remainder considered prime quality (including jumbo and GSE backed pools).

For the overall mortgage market, the MBA's delinquency survey estimates total 30+ days delinquencies to be 4.95% at the end of 2006. This is above the 4.70% in the fourth quarter of 2005, but a far more manageable level than in the subprime segment. For prime mortgages, the 30+ days delinquency ratio was 2.57% in December 2006. This was marginally above the 2.47% in 2005, and relatively consistent with prior years back to 2000.

Clearly problems in the subprime market are not over, especially with estimates that close to $650 billion of subprime ARMs will reach their interest rate reset period in 2007 and 2008. Rising delinquencies may have an impact on available liquidity and future underwriting standards for subprime borrowers, though again this is not an unexpected reaction (or correction) by the credit markets. Since national banks originated less than 10% of subprime loans in 2006, we expect the direct impact of any market correction in the national banking system to be manageable. There may, however, be tangible indirect effects should problems extend to consumer spending, employment, entry-level home prices, etc. To date the most serious problems have been contained within the subprime segment. Nevertheless, we will continue to monitor all market segments closely.

2. What caused these problems in the subprime mortgage market?

It's difficult to make definitive judgments about the underlying causes since the majority of subprime lending occurs outside of the national banking system. We do monitor the mortgage markets closely, however, so we can offer some observations and analysis.

In our view, the adverse conditions can be attributed to a variety of factors, including an abundance of liquidity from the securitization markets and the willingness of loan originators, investors, and borrowers to assume greater levels of mortgage risk. This combination helped fuel growth in several mortgage market segments, including subprime.

In the subprime sector, this growth and increased competition contributed to the rapid development of new and innovative mortgage products. These products were designed to promote payment affordability, help repair credit profiles, and assist in coping with rising home prices. In isolation, these products were not responsible for the full extent of the current subprime issues. However, when accompanied by other factors such as relaxed lending standards, minimal borrower equity and, in some cases, application fraud, the result is a strong contributor to the performance problems we are seeing today.

3. How is the market responding and what effect is it having?

Much has occurred in the past several months in response to deteriorating subprime loan performance. Several non-bank mortgage originators have been sold or forced out of business, while others remain for sale. A number of institutions have announced curtailment in the number and type of subprime products they offer, or have tightened underwriting standards. It's difficult to forecast the full impact of these actions, but we do note that, according to Inside Mortgage Finance, issuance of new subprime mortgage-backed securities were 19% lower in the first quarter of 2007 (compared to the fourth quarter of 2006), and below first quarter issuance levels in both 2006 and 2005.

On a positive note, several institutions, including national banks, have recently announced programs designed to assist troubled subprime borrowers in refinancing their loans and avoiding foreclosure. Many programs involve new loan terms that minimize the potential for significant payment shock and help borrowers plan and manage their payment obligations. Some states have initiated similar programs to help borrowers remain in their homes. In addition, both Fannie Mae and Freddie Mac recently announced their intent to significantly step up purchases of subprime loans to help existing troubled borrowers and to promote liquidity in the market. We are also aware that many mortgage servicers are exploring ways to better implement loss prevention and foreclosure avoidance programs.

The OCC has been proactive in communicating support for these initiatives. We, along with the other financial institution regulatory agencies, recently released a statement on working with mortgage borrowers. The statement encourages financial institutions to consider prudent workout arrangements that increase the potential for financially stressed borrowers to keep their homes. The statement also recognizes that institutions may work in conjunction with reputable organizations to assist borrowers avoid foreclosure through credit counseling.

4. What, if any, is the appropriate role for Congress, or is it too late because has the market already started adjusting?

Congressional interest focuses attention on key issues and helps spur discussion and analysis and the Subcommittee's recent hearings have been extremely helpful in this regard. The growing number of delinquent loans and foreclosures in the subprime market is certainly an issue, particularly now that housing appreciation has slowed. It's also important, however, to ensure that consumers are protected against undue risks while avoiding unintended consequences to credit availability, market efficiency, and the performance of mortgage portfolios. One of the primary objectives should be to avoid jeopardizing market segments that are working well and that have helped raise homeownership rates to historic levels.

We are attempting this balance with the recently-issued nontraditional mortgage and proposed subprime guidance documents. We appreciate the support Congress has shown for these initiatives, and hope that the combination of increased attention and tangible guidance, along with the corrective actions taking place in the markets, will be sufficient to address the issues that we are seeing. We will continue to monitor mortgage market activity closely and evaluate whether actions to date are producing desired results and we stand willing to work with Congress if it decides that additional legislative action is needed.