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Before the U.S. House Committee on Oversight and Government Reform

"Foreclosure, Predatory Mortgage and Payday Lending in America's Cities."

<u>March 21, 2007</u>

Chairman Kucinich, Ranking Member Issa, and members of the Committee, thank you for holding this hearing to examine the problems of foreclosures and predatory lending in the subprime market and their impact on urban America, and thank you for the invitation to speak today.

My name is Josh Nassar and I serve as the Vice-President for Federal Affairs for 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. We are a subprime lender. In fact, we began making 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, taking their first steps into the middle class.

In my remarks today, I will focus on subprime home loans—the development of the market, its characteristics and consequences, particularly for families in urban areas. As I will discuss in more detail, inequities in the market and massive foreclosures are having a devastating effect all over the nation, including urban areas with high concentrations of minority residents.

The performance of the subprime market and subprime foreclosures matter because homeownership is by far the most important wealth-building tool in this country. For millions of families, it ultimately makes the difference between merely surviving between paychecks or building savings for a better future. Nearly 60 percent of the total wealth held by middle-class families resides in their home equity—the value of their home minus the amount they owe on it. For African-American and Hispanic families, the share is much higher, topping 88 percent for both groups.[1]

Another reason the performance of the subprime market matters: Americans are carrying more debt, and today we owe more on our homes than ever before. Even with lower interest rates in recent years, homeowners have been dedicating more of their disposable income (the amount left after paying all essential expenses) to paying their mortgages. In March 2001, the average household spent about nine percent of its disposable income to pay its mortgage. During the third quarter of 2005, households were spending nearly 11 percent.[2]

In a nation where homeownership is so important to financial security, and where so many families are burdened with high debt, it appears that subprime lending is pushing many vulnerable consumers backward instead of forward.

During the past year, CRL has published two research reports that have highly disturbing implications for families seeking to gain a secure position in the middle class. In a report issued last May, our analysis shows that African Americans and Latinos receive a disproportionate share of subprime loans, even when they have similar credit scores to white borrowers. And in December, we issued a report showing that subprime home loans are resulting in a devastating epidemic of foreclosures. At the time the report was issued, some industry representatives said it was overly pessimistic. Today our projections are looking right on track, or even conservative. In fact, a recent analysis by the investment bank Lehman Brothers projects 30 percent losses over time on subprime loans made in 2006.[3]

Most of the research CRL conducts is nationwide in its scope, but our research findings have particular implications for communities concerned about wealth-building. For most Americans, buying a home is the most accessible path to financial security, but today there are serious questions about whether expanded lending in the subprime market has been helpful or harmful. At least one point is clear: subprime lending is having a huge impact on communities of color. It is well established that African Americans and Latinos are paying higher costs for mortgages.[4] In CRL's research, we show that these mortgages are <u>not</u> resulting in sustainable homeownership, and may actually be pushing minority homeowners backward financially instead of helping them build wealth and security.

Under typical circumstances, foreclosures occur because a family experiences a job loss, divorce, illness or death. However, the epidemic of home losses in today's subprime market is well beyond the norm. Subprime lenders have virtually <u>guaranteed</u> rampant foreclosures by pushing risky loans on families while knowing that these families will not be able to pay the loans back. There are several factors driving massive home losses:

- **Risky products**. Subprime lenders have flooded the market with high-risk loans, making them appealing to borrowers by marketing low monthly payments based on low introductory teaser rates. The biggest problem today is the proliferation of hybrid adjustable-rate mortgages ("ARMs," called 2/28s or 3/27s), which begin with a fixed interest rate for a short period, then convert to a much higher interest rate and continue to adjust every six months, quickly jumping to an unaffordable level.

- **Loose underwriting**. It is widely recognized today, even within the mortgage industry, that lenders have become too lax in qualifying applicants for subprime loans.[5] These practices are especially troubling: qualifying borrowers without any verification of income; qualifying borrowers without considering the costs of required property taxes and hazard insurance; and failing to account for how borrowers will be able to pay their loan once the payment adjusts after the teaser period expires.

- **Broker abuses**. Today's market includes perverse incentives for mortgage brokers to make high-risk loans to vulnerable borrowers. Brokers often claim that borrowers engage them for their knowledge and generally believe that brokers are looking for the best loan terms available. Yet brokers also claim they do not need to serve the borrower's best interests.

- **Investor support**. Much of the growth in subprime lending has been spurred by investors' appetite for high-risk mortgages that provide a high yield. The problem is that the investor market reaction occurs only after foreclosures are already rampant and families have lost their homes.

- **Federal neglect**. Policymakers have long recognized that federal law—the Home Ownership and Equity Protection Act of 1994 (HOEPA)—governing predatory lending is inadequate and outdated. Although the Federal Reserve Board (hereinafter, the "Board") has the authority to step in and strengthen relevant rules, they have steadfastly refused to act in spite of years of large-scale abuses in the market. For the majority of subprime mortgage providers, there are no consequences for making abusive or reckless home loans.

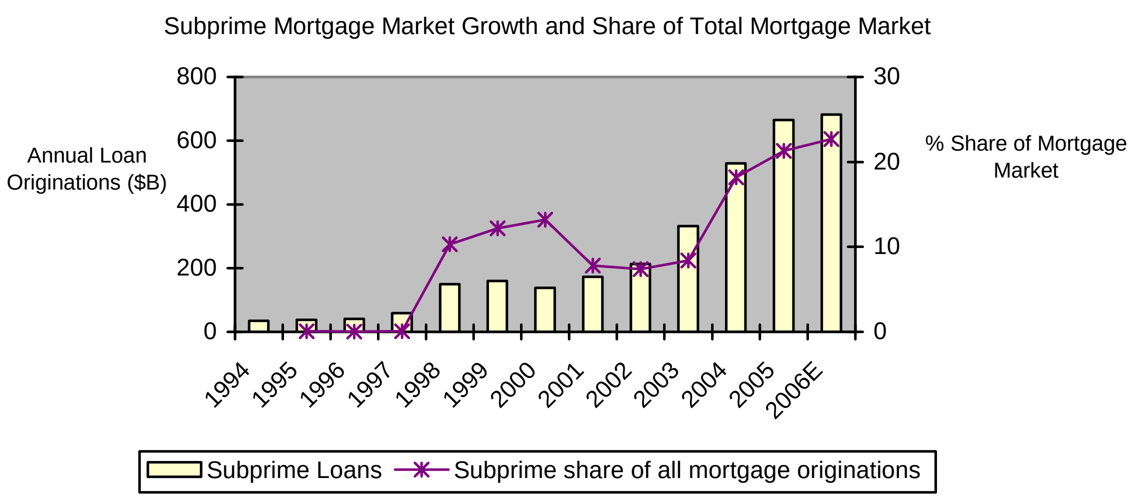
While there is a strong need for comprehensive reforms of the subprime mortgage market, including weeding out abuses in how mortgage servicers handle monthly payments, my primary focus in these comments will be on loan origination practices and how high-risk loans in the subprime market are supported and regulated.

I. The Subprime Market and the Evolution of Predatory Lending[6]

The severe downturn in the subprime markets has been prominent in the media recently, but problems on subprime mortgages are not new. Before discussing the current problems, I would like to provide a bit of context on the growth of the subprime market and the evolution of predatory lending.

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.[7] 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.[8]

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.[9] 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 considering the current state of the subprime market, it is useful to understand how predatory lending has evolved over the past 15 years. 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.[10]

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.[11] The market has expanded at an enormous rate during recent years even while states reported fewer abuses targeted by new laws.

In spite of this success, no one would say that predatory lending has been eliminated. Prepayment penalties continue to be imposed on 70 percent of all subprime loans,[12] and many other "old" predatory practices are still alive and well in today's marketplace: "Steering," when predatory lenders push-market borrowers into a subprime mortgage even when they could qualify for a prime loan; kickbacks to brokers (yield-spread premiums) for selling loans with an high interest rate higher than the rate to which the borrowers actually qualified; and loan "flipping," which occurs when a lender refinances a loan without providing any net tangible benefit to the homeowner.

A. Pricing Issues

Risk-based pricing made the growth of the subprime market possible, but the market has consistently been plagued with questions about whether pricing on subprime mortgages is actually fair. As far back as 2000, a joint report by the U.S. Department of Housing and Urban Development and the U.S. Department of the Treasury noted that "[i]n predominantly black neighborhoods, subprime lending accounted for 51 percent of refinance loans in 1998—compared with only nine percent in predominantly white neighborhoods."[13] The researchers observed that these differences persisted even when adjustments were made to account for differences in homeowners' incomes. Though disconcerting, these observations were not based on a direct measurement of the cost of mortgages, nor did they account for a broader set of risk factors routinely used to determine loan prices.

In 2005, staff to the Board of Governors of the Federal Reserve System analyzed the distribution of these higher-rate loans.[14] They report pricing disparities between different racial and ethnic groups even after controlling for a borrower's income, gender, property location, and the loan amount. For example, after accounting for these differences, African-Americans who took a loan to purchase a home were 3.1 times more likely than white non-Hispanic borrowers to receive a higher-rate home loan; for Latino borrowers, the same disparity stood at 1.9 times.[15]

While this Federal Reserve analysis confirmed that African-American and Latino borrowers were more likely to receive higher-rate loans than white borrowers, the researchers were unable to broadly explore how these disparities were affected by risk factors such as borrowers' credit score, down payment, or ability to document income. To help advance the debate, my organization, the Center for Responsible Lending, has produced the first full research report that addresses this limitation.[16] (The executive summary of that report is submitted with the paper copy of this testimony.)

Specifically, we developed a database of 177,000 subprime loans by matching loans in HMDA to a private database of subprime mortgages. This step allowed us to bring together detailed information on mortgage pricing, loan terms, and borrower risk characteristics in a single dataset. As a result, our study was able to account for those factors and isolate the effects of race and ethnicity in influencing whether a borrower receives a higher-rate loan in the subprime market.

Our findings were striking. We found that race and ethnicity—two factors that should play no role in pricing—are significant predictors of whether a subprime loan falls into the higher-rate portion of the market. Race and ethnicity remained significant predictors even after we accounted for the major factors that lenders list on rate sheets to determine loan pricing.

In other words, even after controlling for legitimate loan risk factors, including borrowers' credit score, loan-to-value ratio, and whether the borrowers documented their income, race and ethnicity matter. African American and Latino borrowers continue to face a much greater likelihood of receiving the most expensive subprime loans—even with the same loan type and the same qualifications as their white counterparts. Across a variety of different loan types, African American and Latino borrowers were commonly 30 percent more likely to receive a higher-rate loan than white borrowers.

B. The Emergence of Riskier Products

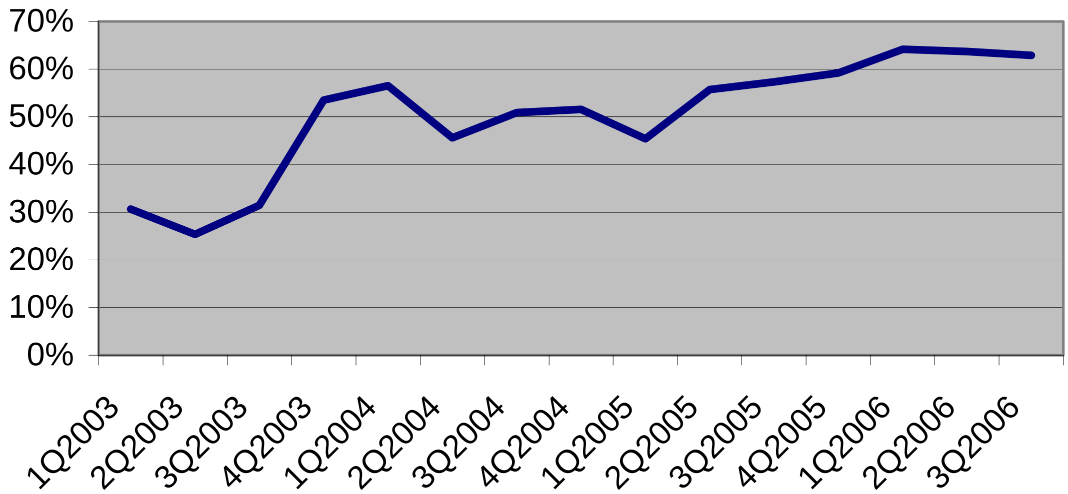
In addition to pricing issues, a more recent concern has emerged in the subprime market: high-risk loan products that were never intended for families who already have credit problems—the 2/28 and 3/27 loans previously mentioned. The risks posed by these loans are magnified further because they are designed 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 payments. In other words, the prohibition against flipping that many states instituted has been defeated by the design of a particular subprime mortgage product that has dominated the market in recent years.

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 also 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.

C. 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.[17] In 2006, lenders reported 318,000 new foreclosure filings for the third quarter alone, 43 percent higher than the third quarter of 2005.[18] 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.[19]

Subprime Foreclosure Starts as a Percent of Total Conventional Foreclosure Starts



Source: MBA National Delinquency Surveys

Figure 2 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. 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 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: increases in mortgage payments and poorly documented 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 also used Moody's Economy.com housing appreciation forecasts to 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 are likely to experience marked increases in subprime foreclosure rates as this appreciation slows or reverses. The data indicate that many urban areas in particular will experience extremely high losses. As one example, here 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. Overall, the greatest jumps in foreclosure rates are clustered in California, where we found 14 of the top 15 largest increases. For example, in the greater San Diego area, foreclosure rates on subprime loans made from 1998 through 2001 were only 3.2 percent, but we project that 21.4 percent of the loans made in that area last year will fail.

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. This report includes a chart showing our subprime foreclosure rate projections in 378 metropolitan areas.

D. 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.[20] 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 affect approximately 12 percent of recent Latino 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.

II. Factors Driving Foreclosures in the Subprime Market

A. Risky Products: 2/28 "Exploding" ARMs

Subprime lenders are 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 to 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 risk 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.[21] 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.[22] 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.[23] 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 judiciously. In fact, hybrid ARMs (2/28s and 3/27s) and hybrid interest-only ARMs have become "the main staples of the subprime sector."[24] 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.[25]

Recently federal regulators issued a proposed statement that explicitly offers greater protections against the risks posed by exploding ARMs. The proposal specifies that depository lenders and their affiliates would be required to consider the potential for unaffordable increases in house payments before approving hybrid ARMs. Specifically, 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.

As regulators receive comments on their Statement, one point 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. One example appeared recently in *The Washington Post*, which published an article about a barely literate senior citizen who was contacted by a mortgage broker every day for a year before he finally took an "alternative" mortgage against his interests.[26] Recently we at CRL 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 A. We also are aware of cases in which the borrower requested a fixed-rate mortgage, but received an ARM instead. The industry itself has asserted 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."[27]

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.[28] 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 higher monthly payment. 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.[29] 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.[30] This deceptive practice gives the borrower the impression that the payment is affordable when, in fact, there are significant additional costs.

A recent study by the Home Ownership Preservation Initiative in Chicago found that for as many as one in seven low-income borrowers facing difficulty in managing their mortgage payments, the lack of escrow of tax and insurance payments were a contributing factor.[31] 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.[32]

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 that "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 have increasingly used these loans to obscure violations of sound underwriting practices.

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."[33]

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.[34]

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 have no 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. 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.[35]

Second, the market, as it is structured today, gives brokers strong 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.[36]

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.[37] 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."[38]

In summary: Mortgage brokers, who are responsible for originating over 70 percent of loans in the subprime market, have strong incentives to make abusive loans that harm consumers, and no one is stopping them. In recent years, brokers have flooded the subprime market with unaffordable mortgages, and they have priced these mortgages at their own discretion. Given the way brokers operate today, the odds of successful homeownership are stacked against families who get loans in the subprime market.

D. The Role of Investors

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 are 2/28s.[39]

We applaud Freddie Mac, one of the largest mortgage investors, for recently announcing 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.

Fannie Mae should follow suit, and should not compete with other investors 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, <u>shall prohibit</u> 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.[40]

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 <u>all</u> 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 refer specifically to high-cost mortgages.[41] By contrast, the authority granted by subsection (l) refers to "mortgage loans" generally.[42]

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.[43] 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.[44] The Conference Report also urged the Board to protect consumers, particularly refinance mortgage borrowers.[45]

The Board has been derelict in the duty to address predatory lending practices, in spite of the rampant abuses in the subprime market and all the damage imposed on consumers by predatory lending—billions of dollars in lost wealth. While the Board has recognized that it has this authority, it has never implemented a single such rule under HOEPA outside of the high-cost context. To put it bluntly, the Board has simply not done its job.

III. 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 <u>sustainable</u> 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 five recommendations:

<u>1. Strengthen protections against destructive home lending by passing a new national anti-predatory lending bill</u>. 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.

2. <u>Restore safety to the subprime market by imposing a borrower "ability to repay" standard for all subprime loans</u>. The federal banking and credit union regulators should adopt the proposed subprime statement that calls on federally regulated banking institutions and their affiliates to make sure lenders underwrite loans to the fully indexed, fully amortizing rate.

<u>3. Require mortgage brokers to have a fiduciary duty to their clients</u>. We know it is both feasible and desirable to require mortgage brokers to serve the best interests of the people who pay them. Brokers manage the most important transaction most families ever make. Their role is at least as important as that of stockbrokers, lawyers and Realtors—professions that already have fiduciary standards in place.

<u>4. Require the Federal Reserve to act, or address abuses through the FTC.</u> 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. Congress has required that the Federal Reserve Board address these problems for all mortgage loans, but to date the Board has not done so. Given the Board's record, Congress should seriously consider enlisting the Federal Trade Commission's assistance in addressing abuses that have gone on too long.

5. 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. By doing so, the agency is providing liquidity to lenders who market abusive, high-risk loans that are not truly affordable. This 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.

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

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] Rakesh Kochkar, "The Wealth of Hispanic Households: 1996 to 2002," Pew Hispanic Center at 5 (2004). See also Gregory D. Squires and Charis E. Kubrin, "Privileged Places: Race, Opportunity and Uneven Development in Urban America," National Housing Institute, Shelterforce Online, issue #147 (fall 2006).

[2] Christian El Weller, "Middle-Class Turmoil: High Risks Reflect Middle-Class Anxieties," Center for American Progress (December 2005).

[3] Mortgage Finance Industry Overview, Lehman Brothers Equity Research (December 22, 2006).

[4] See, e.g., Robert B. Avery, Kenneth P. Brevoort, and Glen B. Canner, "Highest-Priced Home Lending and the 2005 HMDA Data," Federal Reserve Bulletin (amended September 18, 2006); see also Matt Fellowes , "From Poverty, Opportunity: Putting the Market to Work for Lower-Income Families," Brookings Institution, http://www.brookings.edu/metro/pubs/20060718_povop.htm

[5] See, e.g., Vikas Bajaj and Christine Haughney, "Tremors at the Door – More People with Weak Credit are Defaulting on Mortgages," *The New York Times*, citing *Inside Mortgage Finance* (January 26, 2007).

[6] Much of the following material originally appeared in a recent CRL report: 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).

[7] 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.

[8] 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; S*ee 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).

[9] *Subprime Mortgage Origination Indicators*, Inside B&C Lending (November 10, 2006).

[10] See, e.g., Eric Stein, *Quantifying the Economic Costs of Predatory Lending*, Center for Responsible Lending (2001).

[11] 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.

[12] See, e.g., David W. Berson, *Challenges and Emerging Risks in the Home Mortgage Business*: *Characteristics of Loans Backing Private Label Subprime ABS*, Presentation at the National Housing Forum, Office of Thrift Supervision (December 11, 2006).

[13] *Curbing Predatory Home Mortgage Lending*, U.S. Department of Housing and Urban Development and U.S. Department of the Treasury, p47 (June 2000), at http://www.huduser.org/publications/hsgfin/curbing.html.

[14] Robert B. Avery, Glenn B. Canner & Robert E. Cook, *New Information Reported Under HMDA and Its Implication in Fair Lending Enforcement, Federal Reserve Bulletin* (Summer 2005), at http://www.federalreserve.gov/pubs/bulletin/2005/3-05hmda.pdf.

[15] Calculations from Keith S. Ernst and Deborah N. Goldstein, *Comment on Federal Reserve Analysis of Home Mortgage Disclosure Act Data*, Center for Responsible Lending Comment No. 1 (September 14, 2005), at http://www.responsiblelending.org/pdfs/cb001-FRB-091505.pdf.

[16] 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). The study can be accessed at http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf.

[17] 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.

[18] National Foreclosures Increase 17 Percent In Third Quarter, Realty Trac (November 1, 2006) at http://www.realtytrac.com/ContentManagement/PressRelease.aspx?ItemID=1362

[19] *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).

[20] 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), at http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf.

[21] 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.

[22] See, e.g., *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs,* p. 2 Fitch Ratings Credit Policy (August 21, 2006).

[23] 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.

[24] *Structured Finance*, note 20.

[25] *Structured Finance,* note 20.

[26] Kirstin Downey, "Mortgage-Trapped: Homeowners with New Exotic Loans Aren't Always Aware of the Risk Involved," Washington Post (January 14, 2007).

[27] 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.

[28] 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).

[29] 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.”

[30] 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).

[31] *Partnership Lessons and Results: Three Year Final Report,* p. 31 Home Ownership Preservation Initiative, (July 17, 2006) at www.nhschicago.org/downloads/82HOPI3YearReport_Jul17-06.pdf.

[32] In fact, Fannie Mae and Freddie Mac, the major mortgage investors, require lenders to escrow taxes and insurance.

[33] 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.

[34] MBA Research Data Notes, “Residential Mortgage Origination Channels,” September 2006.

[35] 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.

[36] 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.

[37] Remarks by Federal Reserve Board Chairman Ben S. Bernanke at the Opportunity Finance Network’s Annual Conference, Washington, D.C. (November 1, 2006).

[38] 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).

[39] *Inside B&C Lending*, Inside Mortgage Finance, p. 2 (November 24, 2006).

[40] 15 USC Section 1639(l)(2). Emphasis added.

[41] 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)."

[42] 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.

[43] 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."

[44] 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."

[45] "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.