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Before the Senate Committee on Banking, Housing and Urban Affairs

Subcommittee on Housing and Transportation and Subcommittee on Economic Policy

Hearing On

"Calculated Risk: Assessing Non-Traditional Mortgage Products"

September 20, 2006

Chairmen Allard and Bunning, Ranking Members Reed and Schumer, and members of the Committee, thank you for holding this important hearing and for inviting me to testify. I represent the Center for Responsible Lending (CRL), a nonprofit, nonpartisan research and public policy organization dedicated to fighting abusive lending and an affiliate of Self-Help, a community development lender. Self-Help's experience as a lender and CRL's analytic resources provide me both with insight into the impact of non-traditional mortgages on homeowners and recommendations for mitigating the particularly harmful effects resulting from irresponsible subprime lending.

Discussions of the potential threat posed by the prevalence of nontraditional mortgages have been prominent in the last year. As of September 2005, adjustable rate mortgages (ARMs) accounted for roughly 70% of the prime mortgage products originated and securitized and 80% of the subprime sector.[1] CRL commends the federal Agencies for the proposed guidance that they have issued with regard to nontraditional mortgages and concurs with many of the concerns they have raised on this topic. At the

[1] *2006 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis*, FITCH RATINGS CREDIT POLICY (New York, N.Y), Jan. 17, 2006, at 12.

same time, while the Agencies have focused on products such as interest-only mortgages and option adjustable-rate mortgages (ARMs) originated by the entities they regulate, we urge the regulators and this Committee to broaden the scope of concern. Specifically, we encourage regulators to apply the same concerns to subprime finance companies that are not covered by the existing proposed guidance, and to address abuses in hybrid ARM lending in addition to those found in interest-only and option ARM products.

Subprime lending is not a small problem that affects only a few homeowners—one in every four home loans originated in 2005 was a subprime loan, a sector that has $1.2 trillion of mortgages currently outstanding.[2] The vast majority of these loans are hybrid ARMs with a short initial period that offers an artificially low mortgage payment, followed by a significant payment shock for the borrower when the rates reset. Because many subprime lenders fail to consider whether the borrower will be able to afford the mortgage payment after the ARM adjusts, families with these loans are likely to face increasing rates of foreclosure and will lose significant accumulated equity in the coming years. And the impact will not only be on the families that lose their homes. In 2005, subprime originators made 4,225,426 loans totaling $671.8 billion.[3] Our national economy is at significant risk if these loans fail in great numbers, as I fear they will.

The subprime market was designed to serve borrowers who have weaker credit, but by aggressively marketing high-risk ARMs, subprime lenders at a minimum trap their borrowers in a cycle of equity-stripping loans and worse, put vulnerable families at risk of losing their homes altogether. These loans will have a particularly damaging impact on communities of color. According to the most recent HMDA data issued by the

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[2] Inside B&C Lending, 9/1/2006; *See also* INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.
[3] *See* National Mortgage News Quarterly Data Reports, Quarters 1-4, 2005.

Federal Reserve, a majority of loans to African-American borrowers were so-called "higher-rate" loans,[4] while four in ten loans to Latino[5] borrowers were higher-rate. Worse, many borrowers who receive subprime loans could have qualified for a more affordable and responsible product in the first place. Freddie Mac, for example, has publicly commented that one in five subprime borrowers in recent years could have qualified for a lower-cost conventional loan.[6]

In our testimony we will discuss the following four points:

(1) While nontraditional subprime mortgages such as interest-only ARMs and options ARMs are of concern, the even more common hybrid ARMs are "exploding ARMs" that operate as two-year balloon loans. Borrowers largely cannot afford to remain in these loans even if interest rates do not rise at all.

(2) Lenders are failing to consider the borrower's ability to repay the loan after the payment adjusts, and practices such as failing to escrow taxes and insurance or verify a borrower's income only increase the likelihood that the borrower will not be able to repay the mortgage;

(3) Because borrowers cannot repay their subprime loans, foreclosure rates will rise and families will lose significant equity;

(4) Federal regulators can and should address this problem now by requiring that subprime lenders evaluate the borrower's ability to repay before making a mortgage loan.

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[4] 54.7 percent of African-Americans who purchased homes in 2005 received higher-rate loans. 49.3 percent received such loans to refinance their homes.

[5] 46.1 percent of Latino white borrowers received higher-rate purchase loans. 33.8 percent received higher-rate refinance loans. For the purpose of this comment, "Latino" refers to borrowers who were identified as racially white and of Latino ethnicity.

[6] 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).

The need to act is urgent, and the devastation caused by high-risk ARMs in the subprime market is real. As one example, we are familiar with a case now pending in the Eastern District of Missouri involving a thirty-five-year-old single mother of two children, a woman named Velma Vardiman. For several years, Ms. Vardiman faithfully made payments on her fixed-rate mortgage, which had an interest rate of 7.5 percent. In early 2005, Ms. Vardiman was diagnosed with cancer. She was forced to leave her job and apply for disability benefits.

It was during this vulnerable period when a mortgage broker contacted Ms. Vardiman and lured her into a 2/28 mortgage by touting the lower payments. This loan had many costly features: a prepayment penalty, a yield-spread premium, high fees that amounted to 11.5% of the loan amount. But the worst part was that the initial low monthly payments were only temporary, and they did not reflect all of her true housing costs, since the payments did not include the cost of taxes and insurance.

In November, Ms. Vardiman's mortgage will jump from 6.95% to over 11%. Over time, the interest can climb as high as 13.95%. She now faces a dilemma that is becoming all too common among homeowners in the subprime market with exotic ARM products. One option is to seek another refinance—a transaction that will cost her thousands of dollars and drain more of the equity she has worked hard to earn. Or Ms. Vardiman can struggle to keep the loan she has today—a loan that is unaffordable and, under any decent lending standard, never would have been offered to her. Ms. Vardiman has two children, and she is fighting hard to keep her home, but ultimately she may lose it.

This is a choice that homeowners should never have to face. As described in the remaining testimony, non-traditional mortgages in the subprime market are actually acting to reverse the traditional benefits conveyed by mortgages, leaving vulnerable families worse off rather than giving them the opportunity to become more financially secure.

I. "Exploding ARMs": Hybrid ARMs in the subprime market operate as two-year balloon loans.

The dominant product in the subprime market is an adjustable rate mortgage that effectively operates as a two-year balloon. Sometimes referred to as "exploding ARMs" due to the significant increase in the monthly payment after an introductory period with an artificially low payment, hybrid ARMs and hybrid interest-only ARMs have become "the main staples of the subprime sector."[7] Through the second quarter of 2006, 80.7% of subprime loans were adjustable rate loans, predominantly 2/28s.[8] 2/28s are one of the most common types of hybrid ARMs in the market—they include an initial short-term fixed rate for two years, followed by rate adjustments, generally in six-month increments for the remainder of the term of the loan.[9]

While interest-only loans are clearly of concern, representing one in four subprime loans,[10] the even more common 2/28 subprime mortgages themselves pose a significant risk to families as well as the industry as a whole. The low start rate virtually assures the payment will rise significantly when the rate resets, even if interest rates

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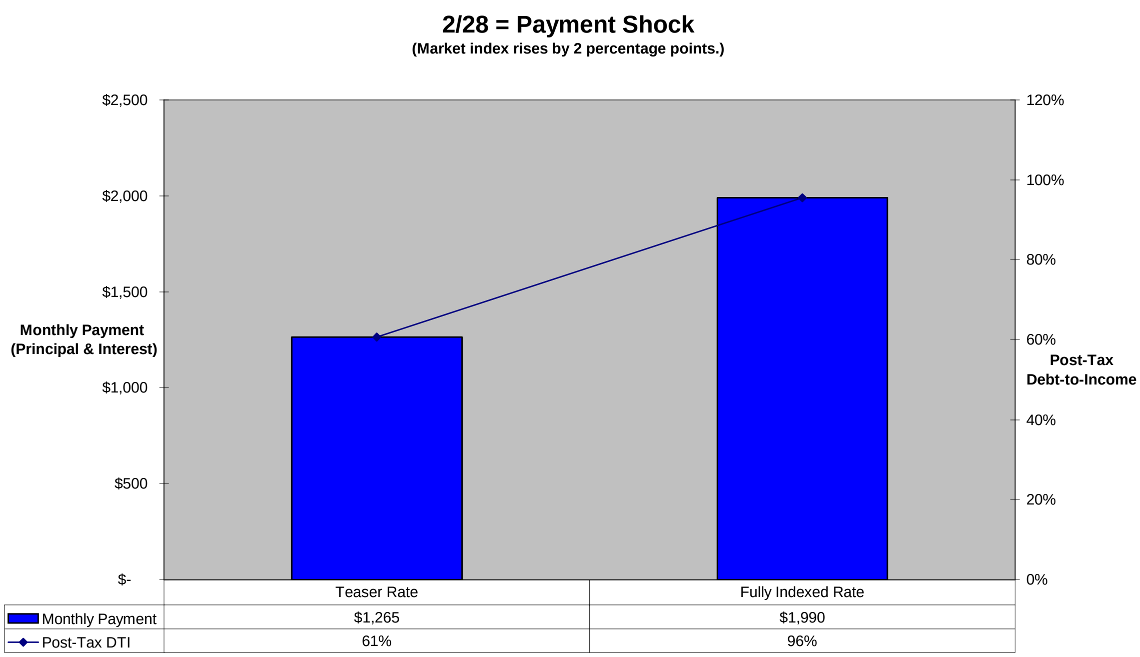
[7] Id.
[8] Figure based on Mortgage Backed Securities through the 2nd quarter of 2006, *see* INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.
[9] See, e.g. *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs,* FITCH RATINGS CREDIT POLICY (New York, N.Y), August 21, 2006, at 2.
[10] Id.

remain constant and do not rise at all. Of course, if interest rates rise, the payment shock will rise as well.

The example below illustrates the severity of payment shock that can occur on the typical exploding ARM:

Figure 1



For the 2/28 ARM shown in the chart, we made conservative assumptions that correspond with typical mortgages of this type, including that the market index rises by two percentage points between origination and the expiration of the introductory rate.[11] At the end of the introductory rate period, the borrower's monthly payment jumps from around $1,265 to almost two thousand dollars ($1,990)—a large amount for most families, and certainly a significant amount for a family that already struggles with debt.

[11] Home value, $225,000; loan amount, $180,000; term 30 years; 2-year prepayment penalty; introductory teaser rate of 7.55%; fully-indexed rate of 13.25%. The hypothetical borrower had an annual income of $30,354 and post-tax income of $24,997, with those incomes selected to reflect the too common practice of underwriting subprime loans to 50% of the borrower's pre-tax income.

Even more striking, the debt-to-income ratio climbs to an astounding 96%, meaning that the homeowner would spend nearly all of his income on his home loan. Put another way, this mortgage payment would leave the borrower with $125 per month to pay for food, utilities, transportation, and all other essential expenses.

Payment shock for borrowers with subprime loans will be widespread in the next two years. According to Barron's, over the next two years, reset of two-year teaser rates on hybrid ARMs will lead to increased monthly payments on an estimated $600 billion of subprime mortgages.[12] Fitch Ratings has stated that in 2006 payments will increase on 41% of the outstanding subprime loans—29% of subprime loans are scheduled for an initial rate reset and another 12% of subprime loans will face a periodic readjustment.

II. Exploding ARMs violate the fundamental underwriting precept that lenders should consider the ability of the borrower to repay the loan.

Lenders who make exploding ARMs often do not consider whether the borrower will be able to pay when the loan's interest rate resets, setting the borrower up for failure. Subprime lenders' public disclosures indicate that they 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 and therefore monthly payment will rise significantly. For example, a recent prospectus shows that a large subprime lender, Option One underwrites to the lesser of the fully indexed rate or one percentage point over the start rate.[13] For a loan with a typical 2/28 structure, the latter would always apply. This practice means that at the end

[12] Jonathan R. Laing, *Coming Home to Roost*, BARRON'S (New York, NY), Feb. 13, 2006, at 26.
[13] *See* Option One Prospectus, Option One MTG LN TR ASSET BK SER 2005 2 424B5 May 3 2005, S.E.C. Filing 05794712 at S-50.

of the introductory teaser rate on an ARM, borrowers face a shocking increase in costs, even if interest rates remain constant.

A lender's failure to account for the incredible payment shock that most borrowers with an exploding ARM will face is compounded by two other practices: failure to escrow property taxes and hazard insurance and limited documentation of income.[14]

Most subprime lenders sell loans based on low monthly payments that do not take taxes or insurance into account.[15] This deceptive practice gives the borrower the impression that the payment is affordable, when in fact, there are additional costs that the borrower will likely need to finance. When borrowers are hit with large tax and insurance bills they cannot pay, the original lender can realize a windfall by enticing the borrowers to refinance the loan, incurring additional fees as the borrower loses equity to pay for the new costs. Given that the typical practice in the subprime industry is to accept a loan if the borrower's debt is at or below 50 to 55% of their pre-tax income,[16] using an artificially low monthly payment based on a teaser rate and no escrow for taxes and insurance virtually guarantees that a borrower will not have the residual income to

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[14] *See, eg.,* " B&C Escrow Rate Called Low" *(February 23, 2005) Mortgage Servicing News Bulletin, July 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."

[15] *See, eg.,* Chase Home Finance Subprime Lending marketing flier, *Attractive* ***Underwriting Niches,*** **at** www.chaseb2b.com (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).

[16] *See, eg.,* OPTION ONE MTG LN TR ASSET BK SER 2006 2 424B5 Jun 28 2006 S.E.C. Filing 06929203 stating "The debt-to-income ratio is generally less than 55%."; *See also,* NEW CENTURY HOME EQUITY LN TR SER 06 2 424B5 Jun 27 2006 S.E.C. Filing 06926211 stating "The maximum debt service-to-income ratio is usually 50% unless the loan-to-value ratio is reduced." In a survey of the rate sheets of Top 10 B&C lenders (as of 9/19/2006), all ten report an allowable debt-to-income-ratio of at least 55%. Notably, Option One allows up to 60% DTI at their lower credit grades, C & CC.

absorb a significant increase in their mortgage payment after two years.[17] 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.

Unfortunately, inadequate documentation of a borrower's income only compounds the problem of underwriting based on the borrower's ability to make payments before adjustment. Fitch recently noted that "loans underwritten using less than full documentation standards comprise more than 50% of the subprime sector . . . ." [emphasis added].[18] Similarly, others have observed that 37% of non-agency mortgage-backed securities were alternative documentation or no documentation loans in 2005.[19] Worse, in reviewing a sample of stated income loans, the Mortgage Asset Research Institute recently found that over ninety percent exaggerated income by 5% or more and almost 60% exaggerated income by over 50%.[20] While in the past a small number of self-employed borrowers used stated income loans, today's figures suggest that brokers and lenders are pushing the product on borrowers who could document their income because

[17] A review of the Federal Reserve Board Consumer Finance Survey found that only 40% of lower income borrowers had escrow accounts and for loans with interest rates of 9% and above, only 12% of low income borrowers had escrow accounts, a much lower figure than the 26% of higher income borrowers with loan rates in the same range. The report posits that "Omitting escrow makes monthly payment burdens appear smaller, and therefore is more attractive to cash-strapped borrowers. However, borrowers who cannot afford a monthly escrow payment are also unlikely to be able to budget for payments for property taxes and property insurance." The report also uncovered a link between delinquencies/foreclosures and failure to escrow, and suggests that requiring escrow could have a positive impact on foreclosure rates and home retention, "As data from 311 line callers (discussed previously) began to suggest that tax and insurance payments are a contributing factor for as many as one in seven troubled borrowers, HOPI partners decided to focus on the use of escrow accounts…. [T]he preliminary research into this area suggests potential for affecting foreclosure rates through increasing the use of escrows." *See* Home Ownership Preservation Initiative, *Partnership Lessons and Results: Three Year Final Report* (July 17, 2006) at 31.

[18] *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs*, FITCH RATINGS CREDIT POLICY (New York, N.Y), August 21, 2006, at 4.

[19] *What Else Is New? ARMs Dominate Subprime Mix*, INSIDE B&C LENDING (Bethesda, MD), Jan. 20, 2006, at 4.

[20] Mortgage Asset Research Institute, Inc, *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, *available at* http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006).

of the premiums that accompany these loans. The MARI report notes, "When these loans were introduced, they made sense, given the relatively strict requirements borrows had to meet before qualifying. However, competitive pressures have caused many lenders to loosen these requirements to a point that makes many risk managers squirm."[21]

Many have portrayed nontraditional subprime loans as "affordability" products, implying that interest-only features and other techniques are used to achieve monthly payments deemed affordable for a borrower with a given income. This notion of affordability is dangerously short-sighted if borrowers cannot sustain payment after adjustment.

Lenders and brokers are doing more harm than simply ignoring the impact of rate adjustments on a borrowers ability to repay. They compound that problem by failing to consider the devastating impact that prepayment penalties have when combined with these exploding ARMs – borrowers are stuck between a rock and a hard place. Approximately two-thirds of subprime loans also include a prepayment penalty,[22] a penalty for paying the loan off before a certain period, trapping the borrower in the loan when they might be able to refinance into a better product. A borrower who concludes that they would be better off to escape a subprime hybrid ARM (before the rate reset makes it unaffordable) and shift into a fixed rate product, for example, must sacrifice significant equity to pay off the penalty.[23] A study by the University of North Carolina suggests that many borrowers in fact pay the prepayment penalty on subprime ARMs,

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[21] Id.

[22] Figure based on Mortgage Backed Securities through the 2nd quarter of 2006, *see* INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.

[23] Assuming, of course, that the borrower can muster up the cash to pay the prepayment penalty, or can get a new loan that includes that fee in the loan amount. Losing that equity can adversely impact the borrower's ability to afford the monthly payment amounts as well.

stating, “ARMs have 40 percent greater odds of prepayment than otherwise identical fixed-rate loans.”[24] To date, it appears that most subprime lenders impose a prepayment penalty for the length of the teaser rate period (i.e., penalty for paying off the loan in the first two years on a 2/28 ARM, penalty for the first three years on a 3/27 ARM), but there is a small number of lenders who will impose the penalty beyond that period.

In addition, subprime loans are increasingly being made available with additional options that limit repayment of principal and equity accumulation (e.g., interest-only, 40/50 year terms, option ARMs that allow for payment of less than full amount due). These terms again facilitate deceiving the borrower into thinking that they are receiving a loan with a low monthly payment, when in fact the payment will adjust to a much higher amount in the future. Worse, the slow or negatively amortizing features of these loans means that when a borrower faces incredible payment shock, and dramatically increases the risk that they will not have the equity to support a refinance. In June of this year, Fitch noted that “in the subprime sector, 8% of the total volume were 2/38 hybrid ARMs, up from less than 1% for all of 2005.”[25] Analyzing payment increases for subprime 2/38 hybrid ARMs, Fitch found the payment increase to be 5% higher than that of a 2/28 hybrid.[26]

Fitch also noted that approximately one quarter of subprime ARMs include an interest-only feature.[27] Interest-only features and longer mortgage terms reduce the amount of principal paid by the borrower for each payment in the early years of the loan.

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[24] Roberto G. Quercia, Michael A. Stegman and 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, University of North Carolina at Chapel Hill (January 25, 2005) at 27.
[25]*See Structured Finance: 40, 45-, and 50-Year Mortgages: Option ARMS, Hybrid ARMS and FRMS,* FITCH RATINGS CREDIT POLICY (New York, N.Y), June 19, 2006, at 4.
[26] Id. at 2.
[27] *Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs,* FITCH RATINGS CREDIT POLICY (New York, N.Y), August 21, 2006, at 2.

With less equity accumulated during those first two to three years, the resulting attempt to refinance at payment reset is even more difficult for the borrower.

III. Because subprime lenders are placing borrowers in loans that they objectively cannot repay, families are losing their homes to foreclosure in ever greater numbers.

Lenders' failure to ensure that borrowers could afford their monthly payment once it increased significantly means that borrowers have one of three options when interest rates reset: refinance, sell the house, or face foreclosure. As families lose home equity and housing markets slow, foreclosure will become the only option for many.

There is already evidence that borrowers with subprime loans cannot sustain payments as rates reset. According to the Mortgage Bankers Association's (MBA's) National Delinquency Survey, in the fourth quarter of 2005 the delinquency rate (90+ days) for subprime ARMs was 2.71%, compared with 0.37% for prime ARMs, over 7 times higher. In addition, USA Today noted that according to MBA figures, "in 18 states, more than 15% of homeowners with subprime ARMs were behind in their payments in the second quarter."[28]

For subprime borrowers with hybrid ARMs who are unable to make payments when the interest rates increase, the repercussions likely will be grave, especially in those markets that have not experienced rapid house price appreciation. To date, a strong housing market and largely favorable interest rates have allowed borrowers with subprime loans to refinance when their payments rise. In this scenario, with each

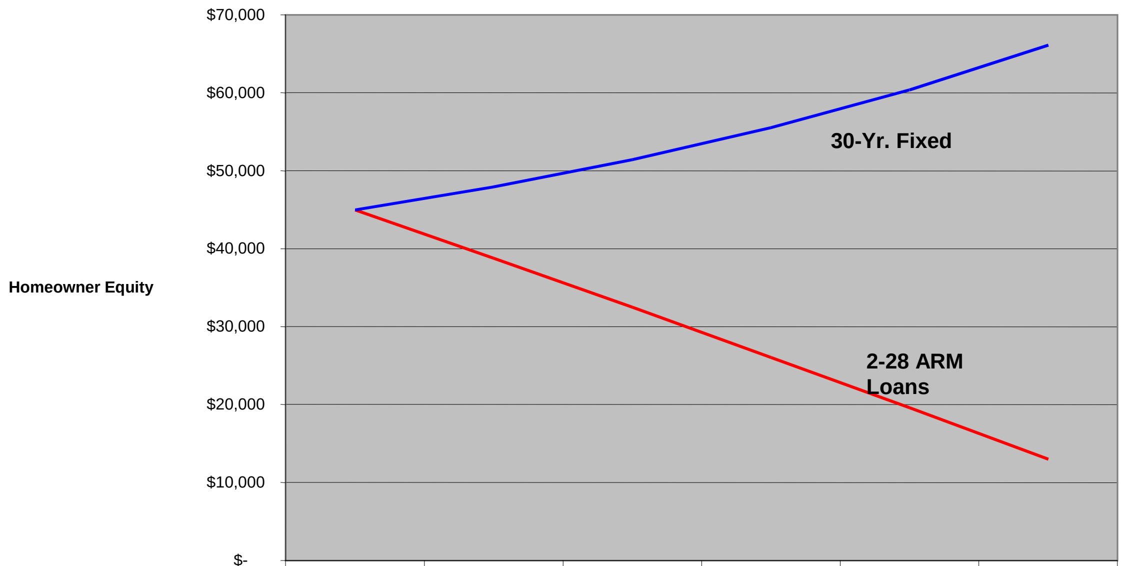
[28] Noelle Knox and Barbara Hansen, *More Fall Behind on Mortgages*, USA TODAY at B1 (September 14, 2006). The USA Today figures refer to total delinquency figures (30 days + delinquent through foreclosure).

refinance, the borrower loses significant equity as they incur a whole new set of lender fees, broker fees, and third-party closing fees with each loan. In turn, this loss of equity means that the borrower loses their single largest source of wealth and ends up trapped in a cycle of subprime loan after subprime loan.

The following figure contrasts the dramatically different ten-year equity-accumulation experience of borrowers who receive a 30-year fixed-rate subprime mortgage with borrowers who receive a series of 2-28 subprime mortgages that are serially refinanced after the expiration of the introductory rate. Borrowers with the 30-year fixed-rate mortgage slowly but surely accumulate equity, strengthening their financial position—by year ten, they have increased their equity from $45,000 to more than $66,000. In contrast, the 2-28 borrowers see their equity swirl down to $20,547—a net difference of more than $45,000. The figure assumes a neutral housing price environment while loan costs underlying this figure are set using identical borrower traits applied to the same lender pricing matrix, assuming 3.5% in lender fees, and $1,910 in third-party closing costs, consistent with bankrate.com's average closing costs.[29]

[29] *Fall 2003 Closing Costs Survey*, Bankrate.com (available at www.bankrate.com/brm/news/mortgages/closing_costs.pdf) (third-party costs include appraisal, attorney, credit report, flood certification, pest inspection, courier, survey, title insurance, and recording fees).

Figure 2: 2/28 = Lost Equity



	0	2	4	6	8	10
2-28 ARM	$45,000	$38,793	$32,490	$26,091	$19,593	$12,996
30 FRM	$45,000	$47,955	$51,442	$55,555	$60,409	$66,136

Time in Loan (Years)

When borrowers lose equity, they represent greater and greater lending risks since proceeds from foreclosure sales are increasingly unlikely to cover amounts owed and administrative costs. As a result, lenders are less willing to make loans available to borrowers in these positions. Today's subprime market has grown tremendously over one of the most favorable interest rate and housing price appreciation rates in recent memory. In fact, strong housing price appreciation has offset the equity-loss effects associated with repeat subprime borrowing, allowing borrowers to tap into equity and refinance time and time again to manage payment shocks and consolidate debt. Yet, as interest rates begin to increase and housing markets slow, the option to refinance is in danger of disappearing for many borrowers with subprime loans. Rather, as subprime ARMs begin to reset there is likely to be a significant rise in foreclosures in a market where, what may come to be seen as the best of times, one in five loans already entered foreclosure and one in eight finish the process within five years of origination.[30] The following figures demonstrate the close relationship between housing appreciation and foreclosures around the country.

The map below shows the cumulative foreclosure experience for subprime loans originated in 2000 based on performance through May 2005. Foreclosure rates vary dramatically across the country and are closely associated with changes in property values. For example, strong housing markets like California and New York experience relatively few foreclosures, while weak housing markets like those in the Midwest tend to experience higher foreclosure rates. Again, these data reflect experiences over a largely favorable interest rate environment. The concern today is that even the strong coastal housing markets are starting to ebb, a development that could send national subprime foreclosure rates soaring.

[30] Roberto G. Quercia, Michael A. Stegman and 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, University of North Carolina at Chapel Hill (January 25, 2005).

Figure 3: Foreclosure Rates Vary with Property Values[31]

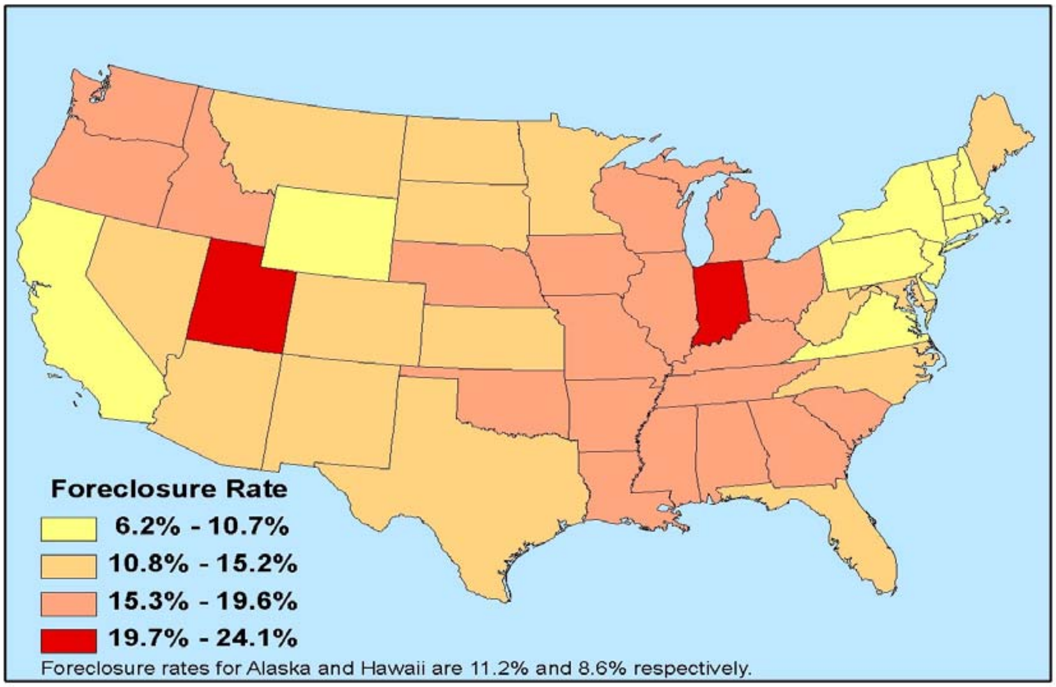


Figure 4 shows the relationship between state-level changes in housing prices and foreclosure rates among subprime loans originated in 2000 (based on performance through May 2005). Even on this elementary measurement, the results are stark, indicating an almost one-to-one relationship between changes in housing price appreciation rates and subprime foreclosure rates.[32]

[31] Source: CRL calculations on private proprietary dataset.
[32] OLS regression shows a highly significant relationship ($p < 0.01$) with an adjusted r-squared of 0.57 and coefficient of -0.92. In other words, for every percentage point decrease in appreciation rates, the model predicts a 0.92 percentage point increase in foreclosure rates. Mean foreclosure rate=13.57%,N=51.

Figure 4: Subprime Foreclosures versus Housing Price Appreciation (Performance of loans originated in 2000 through May 2005)[33]

While subprime foreclosure rates are already rising, rate resets for subprime ARMs will almost certainly contribute to higher foreclosure rates soon. For example, an astounding 11.32% of the subprime ARMs in Ohio were in foreclosure at the end of the second quarter of 2005.[34] UNC has shown that "ARMs' have a strong association with heightened foreclosure risk and potential loss of borrowers' homes," finding that subprime ARMs carried 49% greater odds of foreclosure than that of fixed-rate subprime loans after controlling for other differences in loan terms, creditworthiness, and economic conditions.[35] This relationship will be heightened as housing price appreciation slows.

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[33] Id.
[34] *See* MBA survey cited in Noelle Knox and Barbara Hansen, *More Fall Behind on Mortgages*, USA TODAY at B1 (September 14, 2006).
[35] Roberto G. Quercia, Michael A. Stegman and 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, University of North Carolina at Chapel Hill (January 25, 2005) at 30 and 24.

While borrowers may have been able to offset lost equity from fees and prepayment penalties in the past by an increase in the value of their home and still afford a refinance, as home prices flatten, they will be more likely to lose the refinance option. With the sale and refinance options off the table, foreclosure is the only remaining one for borrowers who hit the rate reset wall.

IV. Regulators can and should ensure that subprime lenders only make loans that borrowers can repay in order to prevent significant losses of equity and devastating numbers of foreclosures.

CRL is pleased that the Agencies are addressing problems with nontraditional mortgages and generally supports the proposed guidance that they have issued. However, the agencies have the authority to expand this guidance to cover nontraditional mortgages made by subprime finance companies, including hybrid ARMs. We urge federal regulators to take the following steps to curb underwriting practices that lead to lost wealth and increased foreclosures:

- Make it an unfair or deceptive act or practice (UDAP)[36] to underwrite subprime ARMs without using the fully indexed interest rate.[37]

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[36] Note that for purposes of this testimony, CRL will not attempt to differentiate between practices that are unfair and those that are deceptive, but rather will recommend that the aforementioned underwriting practices be declared "unfair and deceptive." In general, the standards the Agencies and the FTC use to determine whether an act or practice is *unfair* is that: (1) the practice causes, or is likely to cause (2) substantial consumer injury (3) that is not reasonably avoided by consumers and (4) is not outweighed by countervailing benefits to consumers or competition. For an act or practice to be *deceptive*, the standard is that (1) there is a representation, omission, act or practice that is likely to mislead; (2) the act or practice would be likely to mislead a consumer acting reasonably (if an act or practice targets a particular group, considering reasonableness from that group's perspective); and (3) the misleading representation, omission, act or practice is material.

[37] We support the principle in the Agencies' Guidance, which states: "For all nontraditional mortgage loan products, the analysis of borrowers' repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule.

- Make it a UDAP to exclude hazard insurance and taxes from the analysis of the borrower's ability to repay a subprime home loan.
- Require that all subprime home loans provide for the escrow of payments for taxes and insurance.
- Require independent verification of income reported in low-documentation or no-documentation subprime home loans.[38]
- Increase enforcement against lenders and brokers whose underwriting practices are unsafe and unsound and harm homeowners.[39]

A CRL analysis of 2004 Home Mortgage Disclosure Act (HMDA) data shows that 58% of first-lien subprime home loans were made by non-supervised lenders that reported their data to the U.S. Department of Housing and Urban Development (HUD).[40]

In addition, for products that permit negative amortization, the repayment analysis should include the initial loan amount plus any balance increase that may accrue from the negative amortization provision. The amount of the balance increase should be tied to the initial terms of the loan and estimated assuming the borrower makes only minimum payments during the deferral period." *See* Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249, 77,252 (proposed Dec. 29, 2005). *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20051220/attachment.pdf

[38] *See* Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249, 77,252 (proposed Dec. 29, 2005). *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20051220/attachment.pdf at 17-18 (cautioning institutions to consider whether verification practices are adequate and encouraging increasingly comprehensive verification as the level of credit risk increases).

[39] Additionally, regulators could facilitate better public information about the terms of subprime loans by requiring financial institutions to provide additional information, including loan-to-value ratio, among their Home Mortgage Disclosure Act disclosures.

[40] The HMDA regulations applicable to loans originated in 2004 required lenders to report the difference between an originated first-lien home loan's annual percentage rate and the yield on U.S. Treasury securities of a comparable term if that difference was greater than or equal to three percentage points and the loan was subject to the Truth-in-Lending Act. This new reporting field was developed specifically to allow observers to understand subprime lending patterns. However, there is some evidence that this measure may still underestimate those loans that are subprime in the HMDA data set. For more information, see Avery, R.B., G.B. Canner, and R.E. Cook, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement* (Federal Reserve Bulletin, Washington, DC), Summer 2004 at 344-394, *available at* http://www.federalreserve.gov/pubs/bulletin/2005/3-05hmda.pdf. For further

In other words, a majority of subprime loans are made by lenders that will not be subject to safety and soundness oversight by the agencies. CRL strongly recommends that at least some of the underwriting standards apply to all mortgage lenders and brokers,[41] not only to depository institutions. To accomplish this goal, the FRB could exercise its discretionary authority under the Home Ownership and Equity Protection Act (HOEPA) which provides the Board with broad authority to prohibit unfair or deceptive mortgage lending practices and to address abusive refinancing practices. Specifically:

> "(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."[42]

While this grant of authority occurs in HOEPA, Congress granted this authority to the Board for all mortgage loans, not just loans that are 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. By contrast, the discretionary authority granted by subsection (l) refers to "mortgage loans" generally.

Alternatively, the Agencies could work with the FTC to begin rulemaking proceedings to declare certain acts and practices related to underwriting of nontraditional

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explanation of the lenders that report HMDA data to HUD, see U.S. Department of Housing and Urban Development, Mortgagee Letter 05-17 (April 15, 2005) (detailing who must report HMDA data to the agency).

[41] Mortgage brokers accounted for 59.3% of subprime originations in 2005. *Brokers Flex Their Muscle in 2005, Powering Record Subprime Year*, INSIDE B&C LENDING (Bethesda, MD), Mar. 17, 2006. When a reporting institution makes loans through a mortgage broker, the institution rather than the broker reports the HMDA data. *A Guide to HMDA Reporting: Getting It Right!* (Federal Financial Institutions Examination Council Jan. 1, 2004), at 6.

[42] 15 USC Section 1639(l)(2).

mortgages to be unfair or deceptive acts or practices under Sections 18(a) & 18(f) of the FTC Act, 15 U.S.C. §§ 57a(a) & (f).[43] Section 18 of the Federal Trade Commission (FTC) Act directs the FRB, NCUA, and OTS[44] to "prescribe regulations to carry out the purposes of this section, including regulations defining with specificity such unfair or deceptive acts or practices, and containing requirements prescribed for the purpose of preventing such acts or practices."[45] According to an article written by Julie S. Williams and Michael S. Bylsma of the OCC,

> Congress appeared to have had two primary goals when it amended the FTC Act in 1975. One goal was to strengthen consumer protection under the FTC Act by enhancing enforcement of the FTC Act *through rulemaking*. The other goal was to ensure that there would be *substantial similarity* in the FTC Act regulations that are applicable to banks and those that are applicable to other companies (after concluding that the FRB—not the FTC—would be best suited to develop regulations that are appropriate to banking functions).[46]

Congress clearly has instructed the FRB, NCUA, and OTS to address unfair or deceptive acts or practices through specific regulations.

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[43] Given the need to address abuses related to nontraditional mortgages sooner rather than later, CRL recommends that the Agencies issue final Guidance *before* embarking on a rulemaking process with the FTC.

[44] Since the 1989 abolition of the Federal Home Loan Bank Board, to which Section 18 originally referred, the OTS has been the federal agency that determines for savings associations whether acts or practices are unfair or deceptive.

[45] The (FTC Act both bans unfair or deceptive acts or practices *and* instructs certain of the Agencies to issue regulations to prohibit *specific* unfair or deceptive acts or practices. Section 5 of the FTC Act (15 U.S.C. § 45) states that "unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful." The OCC, the FDIC, and the FRB already have made clear that the general prohibition of Section 5 applies to the institutions they regulate and that they are authorized to enforce that law under Section 8 of the Federal Deposit Insurance Act. See 12 C.F.R. § 7.4008(c); Unfair or Deceptive Acts or Practices by State-Chartered Banks, FRB & FDIC (Mar. 11, 2004) (FRB-FDIC Guidance). See also Guidance on Unfair of Deceptive Acts or Practices, OCC Advisory Letter AL 2002-3 (Mar. 22, 2002); FDIC Financial Institution Letter, Guidance on Unfair or Deceptive Acts or Practices, FIL 57-2002 (May 30, 2002); Letter from Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, to Rep. John J. LaFalce (May 30, 2002). CRL requests that the Agencies not rely simply on Section 5 of the FTC Act, but rather that authorized agencies issue regulations under Section 18.

[46] Julie L. Williams & Michael S. Bylsma, *On the Same Page: Federal Banking Agency Enforcement of the FTC Act to Address Unfair and Deceptive Practices by Banks*, 58 BUS. LAW. 1243, 1248 (May 2003) (emphasis added).

Promulgating unfair or deceptive acts or practices (UDAP) regulations that address some of the worst abuses associated with underwriting of nontraditional mortgages under Section 18(f) also would help "level the playing field" between depository institutions and non-depository institutions. The proposed Guidance as drafted by the Agencies would apply to banks and their subsidiaries, bank holding companies and their non-bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions. Other mortgage lending institutions would not be subject to the Guidance.[47]

[47] CRL notes that if Fannie Mae and Freddie Mac incorporate the final guidance into their own securitization standards, and if the ratings agencies rate favorably only those loan portfolios that comply with the Guidance, then the Guidance probably would have a significant indirect effect on institutions to which the Guidance did not apply directly. Still, regulations would provide for broader and more certain coverage.

Conclusion

Until recently, homeownership has served as a life-line for families to gain security and financial stability, but high-risk nontraditional mortgages are seriously eroding the traditional benefits of owning a home. As we have shown here, the problems are not confined to interest-only and option ARMs. Through hybrid ARMs, families in the subprime market are essentially receiving temporary unstable financing. Even if market interest rates do not rise, these loans can quickly become unaffordable or result in a downward spiral of repeated refinances that drain equity and increase the risk of foreclosure.

Mortgages are complex financial transactions, and the most important one that most families enter. If brokers and lenders are permitted to market high-risk products without considering the homeowner's ability to repay, there are serious consequences for individual families. Ultimately, these consequences will affect entire communities – and entire communities will be left out in the cold.

We respectfully submit that federal regulators *can* and *should* address this problem now by requiring that subprime lenders evaluate the borrower's ability to repay before making a mortgage loan, and also by strengthening enforcement against unscrupulous actors who convince homeowners to accept these loans that set homeowners up to fail.