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Before the U.S. House Committee on Veterans' Affairs
Subcommittee on Economic Opportunity

"The Subprime Mortgage Crisis and America's Veterans"

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Chairwoman Sandlin, Ranking Member Boozman, and members of the Subcommittee, thank you for holding this hearing to examine the foreclosure crisis, a problem that is affecting many veterans. We appreciate the opportunity to speak today.

I offer this testimony as Senior Policy Counsel of the Center for Responsible Lending (CRL) (www.responsiblelending.org), a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. We are affiliated with a community development lender, Self Help, which provides carefully underwritten subprime loans to people who have been under-served by other lenders. Self Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses, and nonprofit organizations, and our loan losses have been less than one percent per year.

EXECUTIVE SUMMARY

It is difficult to overstate the magnitude of today's foreclosure crisis. According to Moody's Economy.com, America's "housing and mortgage markets are suffering an unprecedented downturn," and unless policymakers take significant action, home losses due to unsustainable loans will continue to rise through the rest of this decade.[1] A significant number of .the families who lose their homes will be men and women who have served our country.

This crisis, which has not been confined to the housing market but has impacted the entire economy, has brought our nation to the brink of recession. In the past, families typically experienced foreclosures due to an unexpected personal crisis, such as job loss, illness, divorce, or death. Now, however, the leading cause of foreclosure is the nature of the mortgage loans themselves. This crisis was caused by a number of factors, including the following:

- Dangerous loan products.
- Reckless underwriting.
- No escrow for taxes and insurance.
- Risk layering.
- Broker abuses.
- Wall Street demand for more, riskier loans.
- Lack of oversight and regulation.

Today, we offer a number of policy recommendations aimed at cushioning the impact of the foreclosure crisis on veterans. The first two items relate to all homeowners, while the final three items relate specifically to veterans.

1. Permit bankruptcy judges to fix distressed home loans.
2. Establish common-sense standards for sustainable mortgage origination.
3. Expand the VA home loan program to address the current situation.
4. Assist veterans who are seeking loan modifications.
5. Consider extending period of post-service foreclosure protection.

Below, we describe both the causes and the policy recommendations in more detail.

BACKGROUND

A year ago this month, our organization appeared before the Senate Banking Committee to sound an alarm about the subprime market. At that time, we had just released new research predicting that due to predatory and unsustainable lending practices, 2.2 million families were likely to lose their homes to foreclosure. We knew that those lending practices would cause a crisis in the housing market; indeed, the subprime fiasco is causing the largest disaster in the housing market since the Great Depression.

What we did not anticipate is how extensive a spillover effect the housing crisis would have on the global economy, nor did we anticipate the effects on the prime mortgage market. Irresponsible lending, fueled by Wall Street demand for highly risky loans, has pushed our nation to the brink of recession. Part of the reason for the spillover is that the impact of foreclosure is not confined to the families who lose their homes. In addition, 40 million Americans who pay their mortgage on time also are poised to experience drastic drops in their property value as a direct result of subprime foreclosures.[2] The consequent pullback in spending by homeowners whose properties have lost value is further fueling a downward economic spiral.

The housing crisis is hitting veterans especially hard. As a recent Pentagon study has shown, military personnel are particularly vulnerable to predatory lending,[3] and the financial stresses for many military families have been well documented. Although military personnel on active duty receive some protections related to their mortgages, these protections are phased out when they separate from service.

Illustrative stories are not hard to come by. One case, reported by Newsweek as well as other sources, involved an Iraq war veteran from Kentucky, a man named Shawn Howell.[4] Mr. Howell bought a home for his wife and four children shortly before he was deployed. He felt good about having a secure place for his family while he served his country. Following the advice of his mortgage broker, the Howells took out two adjustable-rate mortgages. The interest rate started at 5.4%, but – just after Howell returned from a difficult and dangerous year in Iraq – the rate shot up to 9.9%. The increase was completely unmanageable, especially since Mr. Howell was no longer receiving combat pay. He took on two jobs and made numerous attempts to contact the lender to find a way to avoid foreclosure. In spite of Mr. Howell's best efforts, the lender, Countrywide Financial, refused to modify the terms of the loan. The Howells weren't able to sell their home, and the lender foreclosed. Today, they live in a trailer.

Another veteran who received an abusive loan testified at a field hearing held by Chairman Filner last November, Air Force veteran Nellie Cooper. Ms. Cooper refinanced her home loan into an adjustable-rate loan. Her mortgage payments ballooned while local property values dropped, which has prevented her from refinancing into a more secure, fixed-rate loan. She testified, "Nobody will finance 92 percent value of a house, and I am getting more in arrears." Cooper, who lives in Oceanside, Calif., was not able to get help from the VA, because right now, except in very rare cases, VA does not refinance mortgages it didn't make originally. She didn't initially buy the house through VA because she was told repeatedly by real estate professionals and brokers that she didn't qualify and the paperwork was "too cumbersome."[5]

What Caused the Foreclosure Crisis?

The foreclosures faced by these veterans are not just the typical foreclosures of years past, such as those precipitated by catastrophic and unforeseen events such as job loss, divorce, illness or death. In many cases, these foreclosures are due to the unsustainability of the mortgage itself, even without any changes in the families' situation, and even where the family qualified for, but was not offered, a loan that would have been sustainable. Moreover, while significant losses so far have been concentrated in the subprime market, it is becoming increasingly evident that the problems are spreading to the Alt-A and even prime markets.

This crisis has been created by a matrix of factors. I have outlined each of these factors below.

Dangerous products. Subprime lenders flooded the market with high-risk loans, making them appealing to borrowers by marketing low monthly payments based on low introductory teaser rates. The most well known of these products is the hybrid adjustable-rate mortgage (ARM), often known as a 2/28 or 3/27. This type of loan begins with a fixed interest rate for either two or three years, then converts to a higher interest rate pegged to an index such as LIBOR. The loan then continues to adjust every six months, which can be as much as 30-50% more than the original rate.

Another complex product that has put many low-income families at risk is the payment option adjustable-rate mortgage (POARM). This product allows people to make monthly payments that do not cover principal and interest, which means that the home experiences "negative amortization" – that is, the principal balance of the loan grows larger – during the period that the minimum payment is being made. Unfortunately, lenders like Countrywide offered these loans to borrowers for whom they were not suited, structured the products so that the payments substantially increase in five years or less when they hit their negative amortization cap, used excessive teaser rates, and failed to document income. Unlike 2/28s, the POARMs that were poorly underwritten are largely Alt-A mortgages as opposed to subprime.

Reckless underwriting. It is widely recognized today, even within the mortgage industry, that lenders became far too lax in qualifying applicants for subprime loans.[6] They underwrote ARMs only to the initial rate, which means they did not even consider how homeowners would be able to pay their loans once the payment adjusted upward, even with rates constant in the economy. Even worse, many lenders qualified borrowers without any verification of income at all, using so-called “stated-income” or “no-doc” loans. Fitch recently noted that “loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector”.[7]

No escrow. Subprime lenders also didn’t escrow for taxes and insurance as prime lenders do, which left many families reeling when those bills came due. This deceptive practice gives the borrower the impression that the payment is affordable when, in fact, there are significant additional costs. A 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.[8]

Risk layering. In many cases, lenders combined multiple risk elements in one loan, such as hybrid ARM products with no documentation of income and no escrow. Regulators have expressed concern about this practice, stating that “risk-layering features in loans to subprime borrowers may significantly increase risks for both the…[lender] and the borrower.”[9]

Broker abuses. 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, in 2006, mortgage brokers originated 45 percent of all mortgages, and 71 percent of subprime loans.[10]

Unfortunately, given the way the current market operates, abuses by mortgage brokers are not surprising. First, mortgage brokers hold themselves out to consumers as trusted advisors for navigating the complex mortgage market: that is the service they sell, and it is the service consumers assume they are buying. Yet, for the most part, brokers deny that they have any legal or ethical responsibility to refrain from selling inappropriate, unaffordable loans, to avoid benefiting personally at the expense of their borrowers, or even to offer homeowners the best loan they qualified for.

Second, the market as it is structured today gives brokers strong incentives to ignore the best interests of homeowners. In the majority of subprime transactions, brokers are paid more by lenders if they deliver mortgages with rates higher than those for which the borrower qualifies. This payment is called a “yield spread premium.” 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. A related problem is racially discriminatory steering, in which lenders or brokers “upsell” minority borrowers into loans more expensive than those for which they qualify. The Wall Street Journal recently commissioned a study that found of those receiving subprime loans originated in 2005, more than half would have qualified for prime loans – in fact, for loans originated in 2006, that number was as high as 61%.[11]

Wall Street demand for more, riskier loans. Wall Street’s appetite for risky mortgages encouraged lax underwriting and the marketing of unaffordable loans. Demand from Wall Street for subprime loans was so intense that it encouraged subprime lenders to abandon reasonable qualifying standards, to forget about standard documentation requirements, and to ignore whether borrowers could actually afford the loan. As Alan Greenspan told Newsweek, “The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We created something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime loan market would have been very significantly less than it is in size.”[12]

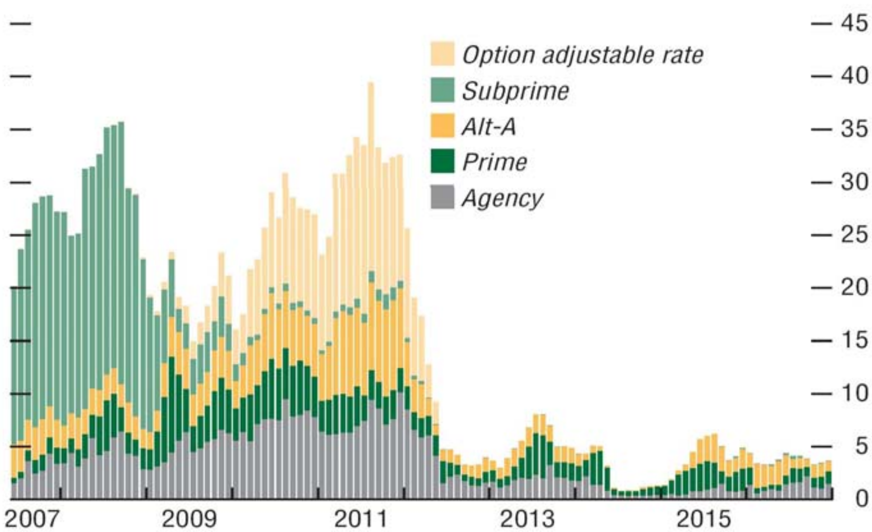
Market participants readily admit that they were motivated by the increased profits offered by Wall Street in return for risky loans. After filing for bankruptcy, the CEO of one mortgage lender explained it this way to the New York Times, “The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,” he said. “What would you do?”[13] Even the chief economist of the Mortgage Bankers Association, when asked why lenders made so many loans that they knew were unsustainable, replied, "Because investors continued to buy the loans."[14]

Lack of oversight and regulation. Policymakers have long recognized that the primary federal law governing predatory lending (HOEPA) is inadequate and outdated. Although the Federal Reserve Board has long had the authority to step in and strengthen relevant rules since the legislation’s passage, they completely failed to do so until this crisis had already unfolded, and now, their proposed rules are significantly weaker than would be necessary to prevent this crisis from occurring again. As for other regulators, not only have most bank regulators taken a hands-off approach until recently, but many of the most egregious abuses were perpetrated by non-bank financial institutions that were largely unregulated. For the majority of subprime mortgage providers, there were no regulatory consequences for making abusive or reckless home loans.

The Crisis is Only Growing

It is important to recognize that while the rate of subprime foreclosures is alarming today, the worst is still ahead. Many additional homeowners will find themselves in trouble due to rate resets on their hybrid ARM, payment option ARM, and interest-only Alt-A loans. Given the slowdown in housing prices, these homeowners will not have the option to refinance or sell that they may have had in the past, increasing the likelihood of foreclosure. As the chart below shows, a large majority of these hybrid ARM rate resets will occur throughout 2008, peaking in October, followed by spikes in payment option ARM resets in 2009, 2010, and 2011.[15]

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

Even worse, we are beginning to see many mortgages originated after 2005 beginning to fail even before the reset date. The laxity in underwriting for these loans was so dramatic that many homeowners cannot even afford the initial monthly payments.

What Can We Do To Help?

While it would be ideal if lenders voluntarily stepped in to rescue homeowners who were given dangerous and abusive loans, such voluntary efforts do not appear to be happening on a scale commensurate to the problem. The Mortgage Bankers Association – after denying for months that a foreclosure crisis even existed – now insists that lenders are making significant efforts to prevent foreclosure, but the numbers belie that claim. During the third quarter of 2007, mortgage lenders started about 213,000 foreclosures on subprime loans, but offered meaningful fixes (“loan modifications”) for only 28,000.[16]

While we welcome the Treasury Department’s Hope Now initiative, which has brought together a coalition of lenders and servicers to encourage voluntary loan modifications, we fear that the portion of the program designed to permit servicers to modify loans without engaging in a case-by-case analysis – the “ASF fast-track modification” – will not help enough homeowners. Only 3% of subprime ARM borrowers are likely to receive streamlined permanent modification under its terms. Repayment plans, which require a subprime ARM borrower to pay the full often 12% interest rate while catching up on delinquent payments at the same time, are ineffective. In the absence of detailed reporting, it is not even clear that the few modifications that have occurred are sustainable. Countrywide has acknowledged that most of its modifications "involved deferring overdue interest or adding the past due amount to a loan," not reducing interest rates or principal balances on subprime ARMs.[17]

To step into this breach, there are a number of actions that Congress can take to help veterans at risk for foreclosure.

1. Permit judges to fix distressed home loans. The best solution to the current mortgage crisis is a small change to the bankruptcy code that would allow courts to make limited modifications to a mortgage loan when the borrower is facing foreclosure, ensuring that the borrower stays in their home and the lender continues to receive a payment stream. This change, H.R. 3609, has passed the House Judiciary Committee in a bipartisan compromise struck by Chairman Conyers and Representative Chabot.

This change does not implicate the 2005 Bankruptcy Code changes, but rather relates to an older provision of the law. Right now, wealthy investors and speculators may receive loan modifications in bankruptcy proceedings for the debt they owe on their yachts, vacation homes and investor properties. Yet current law bars middle-class homeowners from receiving a loan modification to save the roof over their heads. Permitting bankruptcy judges to modify loans on primary residences could prevent as many as 600,000 foreclosures. (In reality, this remedy will accomplish its objective even without requiring most of these families to actually file for bankruptcy. Changing the Code will provide a template for modification and will give servicers the precedent and protection they need from lawsuits by tranches of investors who might otherwise object.)

Making this small fix to the bankruptcy code will be a win-win for homeowners, lenders, neighbors, taxpayers and the economy as a whole. Homeowners can stay in their homes. Lenders will be guaranteed the fair market value of their house, which is more than they would receive at foreclosure sale, and without the lengthy delays and expenses associated with foreclosure. And loans can be modified quickly and effectively.

2. Establish common-sense standards for sustainable mortgage origination. Any solution to the foreclosure crisis also requires that we prevent such abuses from happening again, especially since so many people will need to refinance their current mortgages. In the fall, the House passed H.R.3915 to do just that. While that legislation is a good start, it did not adequately hold Wall Street accountable for its role in this mess. To restore the world's confidence in our markets and recover a reasonable expectation of integrity to our mortgage financing system, we need policy action to realign the interests of people who buy homes, institutions that provide the loans, and the entities that invest in those mortgages.

3. Expand the VA home loan program to address the current situation. Right now, the VA typically does not refinance loans that were not originated as VA loans. It would be extremely useful to consider whether the FHASecure program, aimed at providing rescue loans to homeowners in trouble on their mortgages, could be replicated by the VA. To be most useful, this program would need to permit some level of delinquency on a current mortgage and to limit equity requirements. Furthermore, to encourage more veterans to use VA loans, Congress might consider capping loan fees at 1%, as proposed by Representative Filner in H.R. 4884.

4. Assist veterans who are seeking loan modifications. The VA occasionally assists veterans in negotiating with their lenders to modify a VA-backed loan. Policymakers in several federal and state venues have recognized the need for additional counseling and legal resources to assist homeowners facing foreclosure who seek modifications from the lenders. Congress should consider how the VA can expand its efforts to support veterans in working with private lenders as well.

5. Consider extending period of post-service foreclosure protection. Currently, under the Servicemembers Civil Relief Act, if a lender moves to foreclose on a servicemember's home during the term of service or within 90 days thereafter, a judge may stay the proceedings. Chairman Filner has introduced legislation (H.R. 4883) that would extend this period to a full year. Recent experience with loan modification suggests that ninety days may be insufficient for veterans to get their financial affairs in order and to explore options for saving their homes, especially as they often have many other pressing matters to attend to upon returning home. Congress should consider extending this period of protection.

Conclusion

The subprime lending system has failed our nation's veterans along with millions of other middle-class families. Veterans put their lives on the line to protect our country's security and our way of life. Now, their families are on the verge of losing their homes and financial security, and we all will be worse off as a result.

As outlined here, policymakers have a number of tools at their disposal to mitigate the harm caused by this situation and prevent it from happening again in the future. We greatly appreciate the Subcommittee's interest in the foreclosure crisis, and we look forward to working with you to explore and implement the recommendations that we and others have suggested.

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[1] Testimony of Mark Zandi, "The Looming Foreclosure Crisis: How to Help Families Save Their Homes," before the United States Senate Committee on the Judiciary (December 5, 2007).

[2] See CRL Issue Brief, "Subprime Spillover: Foreclosures Cost Neighbors $202 Billion; 40.6 Million Homes Lose $5,000 on Average," rev. January 18, 2008.

[3] See "Report On Predatory Lending Practices Directed at Members of the Armed Forces and Their Dependents,"August 9, 2006, which can be found at http://www.defenselink.mil/pubs/pdfs/Report_to_Congress_final.pdf.

[4] Dick Gordon radio broadcast, "The Story," American Public Media (June 12, 2007). *See also*, Karen Springen, "This is Not My Beautiful House," *Newsweek* web exclusive (March 28, 2007).

[5] "Mortgage Crisis Hits Home for Troops, Vets," Army Times, December 2, 2007.

[6] 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).

[7] See *Structured Finance,* note 21, p. 4.

[8] *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.

[9] See Interagency Guidance on Nontraditional Mortgage Product Risks, note 42.

[10] See MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006.

[11] See Subprime Debacle Traps Even Credit-Worthy, *Wall Street Journal*, December 3, 2007

[12] "The Oracle Reveals All," *Newsweek* (Sept. 24, 2007) pp. 32, 33.

13 New York Times, January 27, 2007.

[14] "Subprime Loans Defaulting Even Before Resets," CNNMoney.com, February 20, 2008.

[15] See Credit Suisse, Fixed Income Research, October 23, 2006.

[16] See http://www.mortgagebankers.org/NewsandMedia/PressCenter/59454.htm.

17 Gretchen Morgenson, "Can These Mortgages be Saved?" New York Times (September 30, 2007).