Testimony of Paul Leonard
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Before the California Senate Banking Committee
Michael Machado, Chair

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Chairman Machado and members of the Senate Banking Committee: Thank you for holding this hearing to examine the problems of the subprime market and their impact on Californians and the state of California. I appreciate your inviting me to participate. Time could not be more precious, as my organization expects a California foreclosure rate of 21.4 percent – a rate that translates to a direct loss of more than 450,000 homes by the time the dust has settled.

I am Paul Leonard, director of the California office of the Center for Responsible Lending (CRL). 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, 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 also a responsible 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 testimony today, I'd like to make two major points about the implosion of the subprime market and its impact on consumers, communities and the economy:

- **Help Current Borrowers:** Immediate action is needed to help borrowers who are trapped in damaging subprime loans that should have never been originated. Public officials at all levels of government must hold industry players accountable for their actions. Responsibility rests with lenders, servicers, investors and trustees to stem the tide of foreclosures by proactively modifying loans to make them sustainable. There is no longer any dispute that brokers and lenders have placed borrowers into loans that set them up for foreclosures, and the secondary market provided key support and high demand for this reckless lending. Specific remedies will vary depending on the homeowner's situation, but examples of positive actions include converting loans to fixed-rate mortgages with affordable interest rates, writing down principal loan balances, and waiving prepayment penalties. For those borrowers with no equity and no hope of refinancing, the best we can hope for is a "soft landing," but for those who have maintained a degree of equity in their home, this would mean a restructuring of their current mortgage to an affordable level.

- **Strengthen Mortgage Laws to Prevent Future Problems:** While the market has recently "corrected" to tighten underwriting standards, we must establish statutory underwriting standards to prevent a repeat of this crisis when housing prices turn upward. By implementing statutory requirements on all subprime loans—including an assessment of a borrower's ability to repay; requiring escrow for taxes and insurance and income verification, as well as increasing accountability at all stages of the mortgage transaction and crafting a meaningful enforcement framework that enables state regulators to be more effective.

These points are underscored by the speed with which the subprime market has imploded. On January 31, 2007, the Senate Banking Committee convened a hearing to discuss nontraditional residential mortgage products, including the types of loans initiated by many subprime lenders who have since closed their doors.

What a difference a few weeks makes.

Since we last discussed this issue in your committee in January, Wall Street, federal regulators and the media have been in a frenzy as the subprime mortgage market has imploded before our very eyes. We have read reports in all of the nation's leading papers, listened to talk, business and public radio broadcasts and cable and network news reports of the implications of the implosion on housing prices, the economy and borrowers faced with possible foreclosures.

Federal regulators have issued for public comment a new statement applying the principles of their earlier guidance on nontraditional mortgages to subprime hybrid ARMs – requiring new underwriting standards and disclosure requirements for federally-regulated institutions.

Freddie Mac, one of the two large government-sponsored enterprises has promised to stop buying any subprime hybrid ARMs that do not meet the federally-established guidelines.

And some of the nation's largest subprime lenders – many based here in California – have ceased making new loans, announced massive layoffs and seem perilously close to outright bankruptcy. Thousands of California employees have been laid off.[1]

In my remarks today, I will focus on subprime home loans—the development and downfall of the market, its consequences—particularly for families in California—and potential solutions that will prevent similar crises from recurring in the future. I will also offer solutions to rescue current borrowers trapped in mortgages they cannot pay. As I will discuss in more detail, inequities in the market and massive foreclosures are having a devastating effect all over the nation. Regions of California (particularly in the Central Valley) are experiencing sharply increased foreclosures at the moment, and we estimate that the Golden State will lead the nation in foreclosures as our housing prices flatten.

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.

Communities of color are particularly vulnerable to damage in the subprime market. It is well established that African Americans and Latinos are paying higher costs for mortgages, according to data from both the Board of Governors of the Federal Reserve and my organization, the Center for Responsible Lending; our research has found that African American and Latino borrowers were commonly 30 percent more likely to receive a higher-rate loan than white borrowers.[2] The *San Jose Mercury News* recently reported on the plight of subprime limited English borrowers in the San Jose area who have been victims of the subprime lending industry's recklessness.[3]

In a nation where homeownership is so important to financial security, irresponsible subprime lending has the potential to push vulnerable consumers backward instead of forward. In California in particular, where skyrocketing home prices in recent years caused many families to wonder if they could ever afford to own a home, subprime adjustable rate products with discounted initial payments made homeownership temporarily **accessible**, but didn't necessarily make homeownership any more **affordable**.

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[1] "Mortgage Insider," *Orange County Register* by Matthew Padilla at http://blogs.ocregister.com/mortgage/archives/2007/03/peoples_choice_home_loan_files_1.html

[2] Robert B. Avery, Glenn B. Canner and Robert E. Cook, in "New Information Reported Under HMDA and Its Implication in Fair Lending Enforcement," *Federal Reserve Bulletin* (Summer 2005) found that after accounting for a borrower's income, gender, property location and loan amount, 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. http://federalreserve.gov/pubs/bulletin/2005/3-05hmda.pdf

[3] Pete Carey, "The harsh side of the housing boom," *San Jose Mercury News*, March 11, 2007. http://www.mercurynews.com/search/ci_54118.

The bottom line is that access to homeownership means very little if it ultimately ends in home "losership." Over the past nine years, the subprime market has produced more than two trillion dollars in home loans, but only a relatively small portion of these loans have supported first-time ownership—the majority of subprime loans are refinance loans. Between 1998 and 2006, only an estimated 1.4 million first-time homebuyers purchased their home with a subprime loan. Yet over that same time period, there have been many more foreclosures on all subprime loans. In our recent research on subprime foreclosures, CRL estimated that over 2.2 million borrowers who obtained subprime loans will lose or have already lost their home to foreclosure. When we update the analysis to include subprime originations for fourth quarter 2006, the total number of projected subprime foreclosures increases to 2.4 million.[4]

That means that since 1998, subprime lending has led to a net loss of homeownership for almost one million families. In fact, a net homeownership loss occurs in subprime loans made in every one of the past nine years.[5]

Ultimately, the perfect storm of risky loan products, rising home appreciation and aggressive and deceptive marketing to the riskiest of borrowers and a weak regulatory oversight has led us to the subprime market implosion that we are here today to discuss. Much of the press attention, and in fact today's hearing, is focused on whether the collapse will spread to the prime market or its impacts on the national economy. These are important questions. But let us not forget: the most disastrous affects will be felt by borrowers who face the loss of their homes and the ruin of their credit records for years to come.

I would like to address two major themes this afternoon: How we as a state and nation were steered into this crisis, and how we can get out with the best possible outcomes for the most borrowers in trouble. I'd like to start with discussing the characteristics and consequences of the subprime market, and end with recommendations to prevent a recurrence of this or similar crises, as well as offer lifelines to those borrowers who need help immediately.

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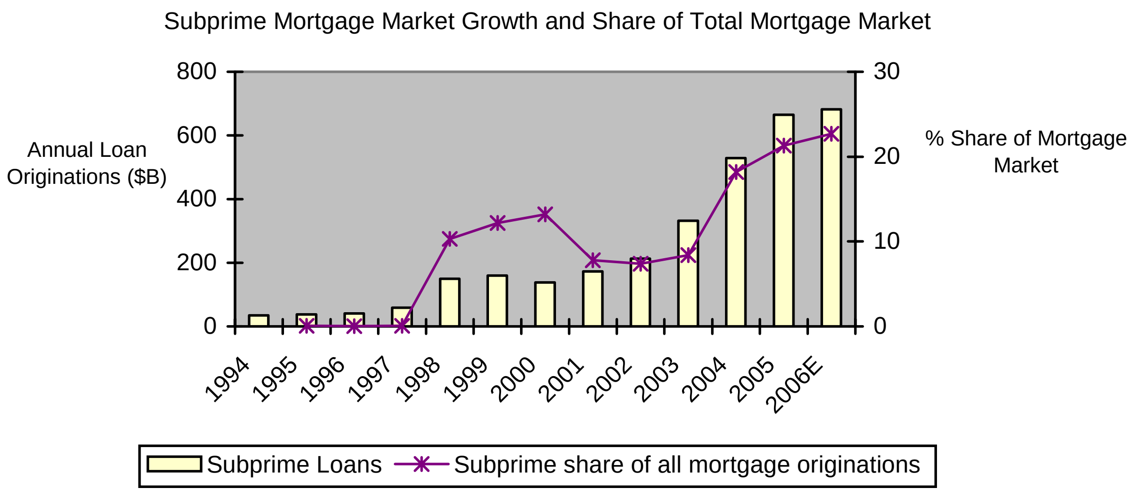
[4] All figures in this analysis cover only loans to owner-occupants in the 50 states and the District of Columbia secured by a first-lien on a single-family home, condominium, townhouse, or a unit in a planned development. 1998-2004 figured derived from a proprietary database of subprime loans sold in the secondary mortgage market between 1998 and 2004. We modified 2005-2006 estimates from *Inside Mortgage Finance* and SMR Research Corporation to account for these criteria.

[5] Our numbers are conservative for two reasons. First, the proprietary database used consists of loans sold on the secondary market, and contains a higher proportion of subprime loans for used home purchase than the overall subprime market. Second, the foreclosure projections were developed by CRL for its recent study *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowner (see full cite in note 7 below)*, and are based on conservative assumptions. Since that report was published in December 2006, other analyses suggest that foreclosures in the subprime market could actually be higher than CRL's projections. See, e.g., Lehman Brothers projects 30% losses over time for subprime loans originated in 2006 (*Mortgage Finance Industry Overview*, p. 4. Lehman Brothers Equity Research, December 22, 2006). If Lehman Brothers' foreclosure projections for 2006 are incorporated with CRL's projections for prior years, the total number of subprime foreclosures originated 1998-2006 climbs to 2.7 million households.

The Subprime Foreclosure Crisis: How Did We Get Here?

Over the last ten years, there has been an explosion in the availability of mortgage credit for low- and moderate-income families with less-than-perfect credit. In 2006, subprime originators nationwide made loans totaling $640 billion.[6] The volume represents a twenty-fold increase since 1994 and a doubling just since 2003. One in every five home loans originated in 2005 was a subprime loan, growing to nearly one in four through the first three quarters of 2006. The sector has $1.2 trillion of mortgages currently outstanding.[7]

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 1994-2005, the subprime home loan market grew from $35 billion to $665 billion; by 2006, the subprime share of total mortgage originations reached 23 percent.[8] 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

In just the last few years, the rise in subprime products that include one or even multiple risky features, coupled with relaxed underwriting standards, have placed many subprime borrowers at undue risk of failure and foreclosure. A recent CRL analysis projects that 21.4 percent of all subprime loans initiated in California in 2006 will result in foreclosure.[9] Taking into account the rates at which subprime borrowers typically

[6] *Inside B&C Lending*, "Top 25 Lenders in 2006" (February 9, 2007)
[7] *Inside B&C Lending*, 9/1/2006; See also Inside Mortgage Finance MBS Database 2006
[8] *Inside B&C Lending* "Subprime Mortgage Origination Indicators," (November 10, 2006)
[9] The data cited in this paragraph is taken from 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).

refinance from one subprime loan into another, this translates into foreclosures for *more than one-third of subprime borrowers*. Our analysis found that California subprime borrowers face particularly large risks: nine of the 15 metro areas with the highest projected foreclosure rates for subprime loans originated in 2006 were in California. Similarly, when we looked at subprime loans originated in 1998-2001 and compared their projected foreclosure rates with projected rates for subprime loans originated in 2006, California metro areas had the top 14 largest increases in home losses.

Further, these loans will have a particularly damaging impact on communities of color, where there is likely to be a high concentration of foreclosures because these communities were targeted by subprime lenders. According to the most recent HMDA data for 2005, 37 percent of African-American and 35 percent of Latinos were higher rate borrowers in California. By contrast, only 14 percent of white, non-Latino borrowers had higher-rate loans.[10] The impact on minority communities is even more concentrated in California's urban neighborhoods. The California Reinvestment Coalition recently found that in most large cities in California, more than half of African-American and Latino purchase borrowers received subprime loans in 2005.[11]

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. Until recently, lenders have reduced the risks of making bad loans by their ability to sell their mortgages to Wall Street firms, who in turn pool, package and sell securities to capital market investors worldwide. Loan originators typically hold mortgages for only a brief period, when teaser rates are still in effect. After that, they are sold to the secondary market, leaving originators off the hook when foreclosures occur.

Recently, as foreclosure rates have sharply increased, investors are looking more closely at underwriting practices that have produced subprime foreclosure rates far higher than predicted. With high levels of these early-payment defaults, investors have demanded the repurchase of bad loans where these practices were not adequately disclosed.

These "market corrections" amount to a classic case of too little, too late for both lenders and borrowers alike. This greater scrutiny of subprime loans by investors may force lenders to make fuller disclosures to investors or curtail excessively risky lending practices, but these changes will be too late for current borrowers, who are already losing their homes, their equity and their credit quality when lenders foreclose on loans that never should have been made, and in fact, were designed to fail.

These factors have come together to create the very situation that CRL predicted in our December 2006 report "Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners." According to our research, 2.2 million borrowers will experience foreclosure, losing approximately $164 billion of wealth in the process. I have brought

[10] CRL analysis of HMDA rate-spread loans.
[11] Kevin Stein, *Who Really Gets Higher-Cost Home Loans? Home Loan Disparities by Income, Race and Ethnicity of Borrowers and Neighborhoods in 14 California Communities in 2005*, California Reinvestment Coalition (December 2006).

with me the executive summary of our study and ask that it be included in the public record.

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. However, 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" when the homeowner's monthly payment quickly skyrockets to an unaffordable level.

Unfortunately, payment shock is not unusual, but is a standard feature of 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. 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. 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. Generally, the interest rates on these loans can only go up, and can never go down. 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." 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.[12]

Recently federal regulators issued proposed guidance that explicitly offers greater protections against the risks posed by exploding ARMs. The proposal specifies that depository lenders and their affiliates should 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. In plain English, this means that the lender should evaluate a borrower's ability to pay after the mortgage payment resets – not just during the first two years when teaser rates apply.

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

In the January 31 California Senate Banking Committee hearing, subprime lenders and mortgage bankers opposed efforts to expand the application of the federal guidance to state-regulated institutions. Remarkably, even as the disastrous consequences of weak underwriting standards and risky loans were coming to light, representatives of New Century Financial Corporation opposed the adoption of responsible underwriting standards for their lending activities. In their testimony they insisted that hybrid ARMs needed no additional regulations or scrutiny. In opposing the application of the federal regulatory underwriting guidance to risky 2/28 and 3/27 ARMs, New Century's representatives argued, "The history and features of hybrid ARMs do not warrant inclusion in the guidance and to do so would cause severe, negative consequences for consumers, the real estate market and the economy."[13] Unfortunately, it now appears that these negative consequences are mounting from the failure to have just those kinds of standards in place.

As noted above, both Freddie Mac and federal banking regulators have called for stronger implementation of the bedrock principle of lender assessment of ability to repay for all subprime hybrid ARMs. This is the most basic and necessary step that should be enacted as quickly as possible by state legislators covering all subprime adjustable rate loans.

B. Loose Qualifying Standards and Business Practices

The negative impact of high-risk loans could be greatly reduced if subprime lenders had carefully screened 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 and features 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 laxity as a key driver in foreclosures. Let me describe some of the most common problems:

Large payment shocks: As I have mentioned, 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 when the interest rate resets.

[13] Oral Statement of New Century Financial Corporation, California Senate Banking Committee hearing on nontraditional mortgage products, (January 31, 2007)

Failure to escrow: The failure to consider payment shock when underwriting is compounded by the failure to escrow property taxes and hazard insurance. In contrast to the prime mortgage market, most subprime lenders make loans based on low monthly payments that do not escrow for taxes or insurance. This deceptive practice gives the borrower the impression that the payment is affordable when there are actually 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.[14] 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. This, again, is in stark contrast to the practices in the prime market of escrowing taxes and insurance and considering these costs when looking at debt-to-income and the borrower's ability to repay.[15]

Low/no income 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. In reviewing a sample of "no doc" loans, the Mortgage Asset Research Institute recently found that *over 90 percent exaggerated income* by 5 percent or more and almost 60 percent exaggerated income by over 50 percent. 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."[16]

C. Broker Abuses and Perverse Incentives

Mortgage brokers are individuals or firms who find customers for lenders and assist with the loan process. Brokers are independent contractors – they 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

[14] *Partnership Lessons and Results: Three-Year Final Report*, p. 31. Home Ownership Preservation Initiative (July 17, 2006) at http://www.nhschicago.org/downloads/82HOP12YearReport_July17-06.pdf.

[15] It is worth nothing that Fannie Mae and Freddie Mac, the major mortgage investors, require lenders to escrow taxes and insurance.

[16] 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); *See also* 2007 Global Structured Finance Outlook: Economic and Sector-by Sector Analysis, FITCH RATINGS CREDIT POLICY (New York, N.Y), December 11, 2006, at 21, commenting that the use of subprime hybrid arms "poses a significant challenge to subprime collateral performance in 2007."

to the Mortgage Bankers Association, mortgage brokers now originate 45 percent of all mortgages, and 71 percent of subprime loans.[17]

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.

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. While brokers in California have a common-law fiduciary duty to borrowers, the subprime mortgage market, as it is structured today, gives brokers strong financial incentives to sell excessively expensive loans to borrowers.

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 of mortgage loans in the hands of financially-motivated mortgage brokers can be a prescription for trouble, as it can lead to behavior that violates fair lending laws.[18] A report issued by Harvard University's Joint Center for Housing Studies concurred: "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."[19]

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 and Ratings Agencies

Lenders sometimes claim that the costs of foreclosing give loan originators adequate incentive to avoid placing borrowers into unsustainable loans, but this has proved false. Lenders have been able to pass off a significant portion of the costs of foreclosure through risk-based pricing, which allows them to offset even high rates of predicted foreclosures by adding increased interest costs. Further, the ability to securitize mortgages and transfer credit risk to investors has significantly removed the risk of volatile upswings in foreclosures from lenders. In other words, high foreclosure rates

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

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

[19] Joint Center for Housing Studies, "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community-Based Organizations," Harvard University, p.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).

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.[20]

Other key players that have played a role in supporting the appetite for risky subprime loans are the credit-ratings agencies, such as Moody's Investors Service, Fitch Ratings and Standard & Poor's. Through last year, these agencies raised no red flags about securities backed by subprime mortgages, and they continued to give investment-grade ratings to these securities based on the segments (or "tranches,") expected to perform the best. The ratings agencies have no stake in supporting investments that, in turn, support key national policy goals, such as sustainable homeownership.

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 by making sure they can make their payments throughout the life of the loan, not just when teaser rates apply. 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. These agencies, with their public mission, should not be permitted to purchase loans to families that do not meet an "ability to repay" standard.

E. Weak State Laws and Regulatory Oversight

California's system for regulating the subprime mortgage industry does not provide an adequate infrastructure for protecting consumers from risky mortgage products and financially motivated brokers. California's mortgage laws do not establish even the most basic protections for underwriting and the Department of Corporations has never examined the underwriting criteria used by state-regulated mortgage originators. Moreover, the Department's 25 mortgage licensee examiners could not possibly be adequate to monitor the activities of some 4,800 licensees originating $150 billion in mortgages each year. Nor is an examination schedule of once every four years likely to be sufficient to evaluate the activities of an industry with a remarkable capacity for product innovation.

The Department of Corporations has also dragged its feet in implementing non-traditional mortgage guidance recommended by federal regulators in November of last year – which

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

don't even cover the most problematic exploding subprime hybrid ARMs. Some 30 state regulators have now taken some action to implement these provisions. As of last week, the Department does not plan to release for comment its proposed rules until May of this year.

California is not alone. Federal regulators have also not been up to the task. When Congress passed HOEPA—the federal anti-predatory lending law—in 1994, one regulatory agency was given explicit authority to take action on predatory lending in the subprime market: the Federal Reserve Board. Congress provided the Board with broad authority to prohibit unfair or deceptive mortgage lending practices and address abusive refinancing practices. Unfortunately, the Board has not applied that authority in any meaningful fashion.[21] This point was emphasized just last week in a Senate Banking hearing, where Roger Cole, the Board's director of banking supervision, admitted that the Board has failed to act promptly to address the crisis in subprime lending. Mr. Cole said, "Given what we know now, yes, we could have done more sooner."[22]

II. The Subprime Foreclosure Crisis: How Do We Get Out?

The crisis in subprime lending will produce record levels of foreclosures. Immediate action is needed on two fronts: 1) help for current borrowers to avoid widespread foreclosures; and 2) statutory and regulatory changes to ensure that this cycle will not be repeated when the housing market turns up again.

A. Help for Current Borrowers

We must act immediately to help those borrowers who are at risk of losing their homes right now. A key principle of any loss mitigation strategy is to assist threatened borrowers, not to bail out lenders and investors who have facilitated this debacle.

<u>**Loan Modifications and Workouts at Scale**</u>: Our highest priority should be creating a system that facilitates large-scale workouts that can help minimize foreclosures. In doing so, we must <u>hold industry players accountable for their actions – lenders, servicers, investors and trustees should stem the tide of foreclosures by proactively modifying loans to make them sustainable.</u> There is no longer any dispute that brokers and lenders have placed borrowers into loans that set them up for foreclosures, and the secondary market provided key support and high demand for this reckless lending. The parties who enabled this crisis should be held fully accountable for minimizing the damage today by taking a proactive role in changing the terms of 2/28s and other abusive subprime loans. Specific remedies will vary depending on the homeowner's situation, but examples of

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[21] The Board did cite section 129(*l*) during its rulemaking process in 2001-02 (including rules on due-on-sale clauses and evasion of HOEPA using open-end loans, although it appears that the authority to issue rules to prohibit evasion of HOEPA is independent); however, it did not propose any prohibitions of acts and practices that would apply to all home loans.
[22] Greg Hitt and James R. Hagerty, "Regulators are Pressed to Take Tougher Stand on Mortgages," *Wall Street Journal* (March 23, 2007).

positive actions include converting loans to fixed-rate mortgages with affordable interest rates, writing down principal loan balances, and waiving prepayment penalties.

This task is made infinitely more complex by the reality that 80 percent of subprime loans are bundled in securities, owned by investors around the world. Loan servicers, who currently collect mortgage payments, have limited flexibility in negotiating workouts on behalf of investors who own securities.

The California Housing Finance Agency may also have a role to play in shaping a workout strategy, as they could bring their expertise and, potentially, resources to bear. But action must be taken quickly, as many homeowners are facing foreclosure right now and more will be joining the ranks in the weeks and months ahead.

Unfortunately, for some borrowers, the best we can hope for is a soft landing. Due to flattening home values and prices, some borrowers will not be able to refinance and they will be forced to sell their homes. However, we should protect them from the additional misery of being liable for any outstanding debt to mortgage lenders after foreclosure.

Cracking Down on Foreclosure Rescue Scams: Another area worthy of legislative attention is to reform the Home Equity Sales Contract Act (California Civil Code § 1695) passed to address the growing problem of purported "foreclosure rescue consultants" taking advantage of homeowners whose homes were in foreclosure. HESCA recognized that homeowners in foreclosure are particularly vulnerable and susceptible to fraudulent activity and need protection. Unfortunately, the protections of HESCA are incomplete and in some ways actually provide a "roadmap" for the potential scammer. Our organization has worked with a number of consumer attorneys to develop suggested revisions to HESCA to provide homeowners facing foreclosure with added protections and to close unintended loopholes in the existing statute.

B. Establishing a Stronger Statutory and Regulatory Framework

Belatedly, California regulators are now in the process of developing new regulations to implement the federal non-traditional mortgage guidance. This guidance should be extended to the subprime hybrid ARMs which are the biggest source of problems in the subprime mortgage market. Stronger statutory actions are needed to ensure that these changes are permanently embedded in California law, with meaningful enforcement mechanisms. In order to prevent this crisis from recurring, California should adopt a number of policy recommendations, including:

Ability to Pay Standards: One of the hallmarks of the subprime market is a lack of attention to a borrower's ability to repay the loan beyond the initial teaser rate period. Borrowers who are already stretching to pay their mortgage at the initial teaser rate will not be able to afford to make payments when their loan enters its third year and the payment rises sharply. Brokers and lenders are not required to ensure that borrowers can afford to pay at the fully-indexed—not just the teaser—rate. This must change, and ensuring that borrowers can afford to repay their loan over the life of the loan will go a great distance in preventing future foreclosures.

Additionally, brokers and lenders should be mandated to require escrow accounts for taxes and insurance, to avoid an unexpected financial squeeze for the borrowers.

We should also mandate a return to the sound underwriting principles that have guided the mortgage industry for decades by requiring income verification for all subprime loans. Currently, products exist that require little or no income verification, which means that borrowers and brokers may be tempted to inflate income.

Limitations on Prepayment Penalties: In addition to having been originated without sufficient income verification, many subprime mortgages include costly prepayment penalties, which often forces borrowers to pay thousands of dollars in penalties to refinance into a better mortgage product. Prepayment penalties—despite efforts by the states to limit their use—continue to be applied to 70 percent of all subprime mortgages.[23] California should prohibit prepayment penalties on subprime loans.

At minimum, California should require a ending prepayment penalties with sufficient time to allow a borrower to refinance a loan at least 120 days before the mortgage payment resets.

Originator Duties: We must realign incentives to get the best loans for borrowers, not the best commissions for brokers. Brokers at this moment have bifurcated duties: on one hand, they are driven by yield-spread premiums (YSPs) – the kickback paid to the broker for originating loans at higher rates; on the other hand, borrowers often expect the broker to have their best interests at stake. Unfortunately, this is not your parents' mortgage market, and brokers are currently neither lenders nor friends to borrowers—much to the surprise of many homebuyers. YSPs should be counted with other fees in determining whether a loan is a high-cost loan in California and prohibited from being combined with prepayment penalties in the same loan.

Lastly, lenders should be liable for brokers and their actions. They are in the best position to spot abusive practices, and they have at least an ethical and—ideally—a legal obligation to protect their customers.

Assignee Liability: In today's climate, when mortgages are bundled and sold on the secondary market, determining who has ultimate responsibility for irresponsible mortgages is difficult. Establishing assignee liability means that borrowers would be allowed to pursue legal claims against the assignee when the loan transaction involved illegal or abusive terms. When liability is assigned to the purchaser of the loan, there is clear accountability. If a loan goes into foreclosure as a result of abusive or illegal practices, the borrower would be able to pursue legal action that might save his or her

[23] 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).

home. A number of states have incorporated appropriate measures to ensure that the secondary markets help to provide accountability for loan originations.

Conclusion

This foreclosure epidemic threatens not only individual families and homeowners in California, but entire communities, neighborhoods and local economies. Until recently, homeownership has served as a lifeline for families to gain security, financial stability and wealth, but high-risk nontraditional mortgage products and the lack of appropriate regulation and oversight of the subprime industry are seriously eroding the traditional benefits of owning a home.

It is imperative that California act affirmatively to address the foreclosure crisis and the collapse of the subprime market so that we can 1) prevent future recurrences of similar problems and 2) help current borrowers in the gravest need as soon as possible.

We can achieve the first goal by establishing statutory requirements on all subprime loans—including assessment of a borrower's ability to repay, requiring escrow accounts for taxes and insurance and requiring income verification; realigning incentives to get borrowers the best loans and making lenders liable for the actions of brokers; limiting prepayment penalties; assigning liability to lenders and investors and crafting a meaningful enforcement framework that allows the Departments of Real Estate and Corporations to be more effective and provides adequate resources for enforcement and monitoring.

Those borrowers at risk of losing their homes can be helped by broad-scale workouts to avoid many of the 450,000 foreclosures we expect to see in California. This means a soft landing for those who are under water with no hope of refinancing, and a restructuring of current mortgages to affordable levels for those who have maintained some equity in their home.

Thank you for convening this hearing, and for giving me the opportunity to add to this very important discussion.