Testimony of Eric Stein
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Before the U.S. Senate
Committee on Banking, Housing and Urban Affairs

"Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis"

October 16, 2008

Good morning Chairman Dodd, Ranking Member Shelby, and members of the Committee. Thank you for holding this hearing on the causes of the financial crisis and for inviting me to testify.

Introduction

I am Eric Stein, senior vice president 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. CRL is an affiliate of Self-Help (www.self-help.org), a nonprofit community development financial institution that consists of a credit union and a non-profit loan fund, of which I am also chief operating officer.

For close to thirty years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to get home loans. In other words, we work to provide fair and sensible loans to the people most frequently targeted for predatory and abusive subprime mortgages. In total, Self-Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across America. Self-Help's lending record includes our secondary market program, which encourages other lenders to make sustainable loans to borrowers with blemished credit. Self-Help buys these loans from banks, holds on to the credit risk, and resells them to Fannie Mae. Self-Help's loans have performed well—our loan losses have been under 1% per year—and increased these families' wealth.

In February 2007, Self-Help's CEO appeared before this Committee and called the subprime market "a quiet but devastating disaster." In that testimony, he outlined our research that showed the subprime mortgage market was heading toward a destructive rate of foreclosures—a projection, at the time, that was called "wildly pessimistic."[1] Given the current financial crisis, which is much broader in scope and more severe than we had foreseen, we wish that charge had been true.

Solutions:

Because at bottom the problem is rooted in excessive foreclosures of unsustainable loans, the solutions must address this problem. Foreclosures are a tragic event in the lives of a family losing their home, but it does not affect them alone – neighbors lose property value and increase the likelihood that they too will be foreclosed on; municipalities lose tax revenue just when demand for their services rises to deal with vacant homes and greater crime; and the economy loses purchasing power when it can least afford it. Voluntary loan modifications have not prevented the foreclosure crisis from escalating. I discuss additional solutions below, but I would like to focus on five:

- Congress should lift the ban on judicial loan modifications, which would prevent hundreds of thousands of foreclosures without costing the taxpayer at all. A loan on a family's primary residence is the only debt that cannot be restructured in a chapter 13 bankruptcy, even though investment banks like Lehman have this ability; courts need the authority to modify loans when families can afford a market rate mortgage when voluntary modifications cannot be accomplished.

- Treasury should embark on a concentrated, multi-pronged effort to increase affordable loan modifications made through the Troubled Asset Relief Program (TARP). A key recommendation is to use TARP's authority to embark on streamlined modifications similar to what FDIC has done with loans owned by IndyMac, targeting the 34% debt-to-income ratio that is part of the recent settlement of state Attorneys General and Bank of America over Countrywide's practices. Treasury should require this structure from banks it purchases assets from or invests equity in, and use it when the government controls whole loans or guarantees modified loans.

- Congress should merge the Office of Thrift Supervision into the Office of the Comptroller of the Currency, eliminate the thrift charter and transfer the holding companies to the Federal Reserve. The OTS has proven not up to the task of protecting consumers or the public from abusive lending practices.

- The Federal Reserve should extend its HOEPA rule to prohibit yield-spread premiums on subprime and nontraditional mortgages, and extend the protections provided for subprime to nontraditional loans.

- Congress should pass the Homeownership Preservation and Protection Act (S 2452) sponsored by Senator Dodd. As this Committee is aware, this bill would establish new protections for consumers and stop many of the abuses discussed in this testimony. Critically, Congress should ensure that assignee liability provisions in the bill are retained in order to realign the perverse incentives that encourage unsustainable loans. Passage of this bill into law would go a long way toward restoring consumer and investor confidence, which will be essential to achieving a full economic recovery.

Causes:

In my testimony, I will discuss four key points regarding the causes of the crisis:

1. Dangerous lending greatly inflated the housing bubble, and the resulting foreclosures are magnifying the damage of the bubble's collapse.

During the current decade, the volume of subprime and Alt A lending expanded tremendously as Wall Street securitized these loans and made virtually unlimited capital available to subprime lenders. To increase loan volume, lenders adopted even riskier practices and products, such as loans that produced high payment shock. These loans were packaged into private-label securities that received AAA ratings from the rating agencies.

This surge in lending spurred historically high house appreciation—the housing bubble. At the same time, this appreciation temporarily hid the long-term unsustainability of these mortgages, as lenders refinanced troubled loans using the home equity gained from higher housing prices. In fact, when borrowers expressed concerns about future payment increases, lenders routinely told them not to worry about it, since they could always refinance.

The rest of the story is well known. The bursting of a housing bubble is always a painful economic event, but the effects of today's falling prices are severely exacerbated by millions of needlessly dangerous mortgages that have failed, or are poised to fail. Refinances became scarce, and unsustainable mortgages turned into the massive foreclosures we are continuing to see today.

Loan modifications can adjust these mortgages to bring them in line with the real market value of the property, but voluntary modifications have not restructured unsustainable loans in nearly great enough numbers.

2. The central cause of this dangerous lending was Wall Street demand for the riskiest, highest-cost loans. That is where blame is primarily due. Wall Street was aided by lenders responding to that demand and credit ratings agencies that provided high ratings on demand.

With all the complexity of today's financial crisis, it's easy to lose sight of the fact that this began in the late 1990s with subprime lending, when subprime lenders put increasing numbers of families into expensive and unnecessarily risky home loans, most often refinances of existing loans.[2]

The fact that Wall Street paid the most for the most dangerous mortgages meant that originators provided these loans, often regardless of their ultimate sustainability. As a result, lenders like Countrywide had pricing policies to pay originators more if they put borrowers in more dangerous loans, rather than safer ones. Unsurprisingly, the loans more likely to result in foreclosure were generally the ones that were originated at higher rates than the borrower qualified for. These loans were then packaged into private-label securities that received AAA ratings from the rating agencies, who were being paid by the very issuers of the securities.

3. This lending binge was abetted by regulators who ignored the risks.

This great experiment in subprime and Alt A securitization took place largely unhindered by any meaningful rules. Imagine a scenario where the most dangerous intersections have no traffic signals. When the police are asked to intervene, they decline, saying they don't want to stop the free flow of traffic. Meanwhile, the collisions keep piling up until the wreckage is a problem for everyone.

When advocates or lawmakers suggested strengthening oversight on the sector providing the riskiest home loans, the inevitable response was, "We don't want to stop the free flow of credit." Unfortunately, the ideology that lending should not be restrained at any cost infected most agencies, particularly the Federal Reserve under Chairman Greenspan, who had the power to issue rules outlawing unfair and deceptive mortgages across the country, and the Office of Thrift Supervision. Today it is abundantly clear that the *lack* of common-sense rules—which should have been applied by agencies with specific duties to ensure safety and soundness in the market and protect families—has impeded the flow of credit beyond anyone's wildest dreams.

4. The architects of this crisis are seeking to divert attention from their own culpability by blaming the Community Reinvestment Act (CRA), homeowners, and the government-sponsored enterprises (GSEs) trying to meet their housing goals.

CRA was passed in 1977, and neither requires nor governs subprime lending, and it doesn't even apply to most originators who supplied subprime loans. Although there were borrowers who knowingly overreached on their loans, Wall Street's demand created an environment where lenders were all too ready to convince borrowers to take complicated loans few families understood. Investment banks led the development of the subprime market. While Fannie Mae and Freddie Mac did invest in the marketable senior tranches of subprime securities that were created by Wall Street, their credit losses have primarily come from Alt A loans made to higher income borrowers, which has nothing to do with their affordable housing goals. Further, had they not stepped up to support the housing market when private securitizations ground to a halt, our economy would be in substantially worse shape than it is now.

I. SOLUTIONS

The gravity of the current crisis underscores the need for systemic changes to be made to prevent another one. The most urgently needed actions are those that will, in the very near-term, stop the vicious cycle of falling home values and foreclosures. We recommend the legislative and administrative actions we believe will do so most effectively. In addition, in Appendix B, we set forth three fundamental principles that must guide any longer-term solutions.

A. CRITICAL IMMEDIATE ACTIONS NEEDED

The most pressing actions needed today are those that will assist existing homeowners to stay in their homes and, by extension, help their neighbors and the financial system as a whole—since financial institutions will not survive if their loan-related portfolios continue to hemorrhage.

We recommend several key actions:

(1) lifting the ban on judicial loan modifications of mortgages on principal residences;

(2) several administrative actions to ensure the Troubled Asset Relief Program (TARP) results in as many loan modifications as possible;

(3) additional legislative actions to make TARP more effective;

(4) and other legislative actions to induce loan modifications.

1. Congress should lift the ban on judicial loan modifications, which would prevent hundreds of thousands of foreclosures without costing the taxpayer at all.[3]

The most effective action Congress can take to immediately stem the tide of foreclosures, and *at zero cost to the U.S. taxpayer*, is to lift the ban on judicial loan modifications for primary residences. Judicial modification of loans is available for owners of commercial real estate and yachts, as well as subprime lenders like New Century or investment banks like Lehman Bros., but is denied to families whose most important asset is the home they live in. In fact, current law makes a mortgage on a primary residence the only debt that bankruptcy courts are <u>not</u> permitted to modify in chapter 13 payment plans.

Judicial modification would provide judges the authority to modify mortgages and would help more than 600,000 families stuck in bad loans keep their homes. Current proposals provide that modifications would narrowly target families who would otherwise lose their homes and exclude families who do not need assistance.[4] They would also provide courts with only limited discretion—interest rates must be set at commercially reasonable, market rates; the loan term may not exceed 40 years; and the principal balance may not be reduced below the value of the property. Judicial modifications would also help maintain property values for families who live near homes at risk of foreclosure. And it would complement programs that rely on voluntary loan modifications or servicer agreement to refinance for less than the full outstanding loan balance.

Voluntary modifications and refinancings are the goal. Judicial loan modification would induce more voluntary modifications outside bankruptcy because everyone would know the alternative,[5] thereby removing the obstacles posed by threat of investor lawsuits. And if the servicer agrees to a sustainable modification, the borrower will not qualify for bankruptcy relief because they will fail the eligibility means test. As Lewis Ranieri, founder of Hyperion Equity Funds and generally considered "the father of the securitized mortgage market,"[6] has recently noted, such relief is the only way to break through the problem posed by second mortgages.[7]

2. Treasury should embark on a concentrated, multi-pronged effort to increase affordable loan modifications made through the Troubled Asset Relief Program (TARP).

The recently passed TARP did not go far enough to ensure sustainable modifications. Lifting the ban on judicial loan modifications should have been included in the package, and, at the very least, the legislative provisions discussed in section 6 below also should have been included. However, TARP can still be used as a powerful tool to stem foreclosures if Treasury promptly takes the following actions:

- ***Require an FDIC-like modification plan for all home loans owned by any bank in which Treasury purchases an equity interest or from which Treasury buys securities***. Treasury should use TARP's authority to embark on streamlined modifications similar to what FDIC has done with loans owned by IndyMac, targeting the 34% debt-to-income ratio that is part of the recent settlement of state Attorneys General and Bank of America over Countrywide's practices. Treasury should require this structure from banks it purchases assets from or invests equity in.

- ***Continue and expand these efforts to modify loans within the control of the government*** by purchasing whole loans when possible and modifying loans owned or controlled by Fannie Mae and Freddie Mac. The GSEs are already becoming more aggressive in their modifications and are working with the FDIC where they are the investor in IndyMac loans. The government should be making similar efforts across the board, with all loans they own or control.

- ***Use the new guarantee authority to provide guarantees to sustainable modifications.*** TARP allows Treasury to guarantee modified loans. Such guarantee could provide significant incentives for modification, perhaps great enough for servicers and trustees to convince investors to liberalize any restrictions against modifying in the Pooling and Servicing Agreements (PSAs), and will require a lower expenditure of funds than buying the loans directly. To be worth the risk to taxpayers, however, Treasury must condition its guarantee on meeting sustainability standards for modification—for example, a payment reduction of at least 10 %; a debt-to-income ratio on housing debt post modification of no more than 34 %; an interest rate reduction for the life of the loan; principal reduction to 95% of current value; and settlement on any second mortgage. This approach is similar to the Hope for Homeowners program, though the transaction costs on a modification/guarantee should be lower than an FHA refinance.

- ***Buy servicing rights***. Treasury can break the modification logjam presently caused by understaffed and sometimes uncooperative servicers. Unless we can change restrictive PSAs that govern servicer discretion to modify, the initial focus should be to buy master servicing rights where the PSAs provide the servicer with more flexibility. Master servicing rights shouldn't cost more than about 1% of the outstanding balance and are an eligible "troubled asset" under TARP.

- ***Purchase second mortgages to gain control of them*** so that they can be consolidated with the first mortgages and restructured. Second mortgages are one of the greatest obstacles to modifications because a first mortgage holder will not generally voluntarily reduce interest or principal only to increase return for a second mortgage holder or cure its loan if the borrower is still in default on a second. Yet most second liens are underwater and could be purchased cheaply. To achieve this, Treasury must identify the owner of the first mortgages and coordinate efforts, or buying the second mortgages won't result in modifications of the firsts.

- ***Establish a section within Treasury to lead the loan modification efforts***.

- ***Set specific goals for sustainable modifications with detailed reporting to increase transparency.***

3. Congress should merge the Office of Thrift Supervision into the Office of the Comptroller of the Currency, eliminate the thrift charter and transfer the holding companies to the Federal Reserve.

CRL supports the Treasury Department's proposal to phase out the thrift charter over a two-year period and merge OTS into the OCC. Eliminating OTS won't cure all of the banking system's regulatory ills. But it would eliminate one of the perverse consequences of the current "regulatory bazaar"—in which regulated institutions get to shop for their regulators—and be an important step in the overall effort to fix the nation's broken regulatory system.

We emphasize that improving the federal regulatory scheme shouldn't require sacrificing the dual state-federal banking system. The modest number of state-licensed thrifts operate efficiently and are small enough that state regulators have adequate resources to oversee them. State licensing also can serve as a counter to the massive consolidation that's now happening in the banking industry; it will preserve smaller financial institutions that are sensitive to concerns of local communities, provide cost-effective choices for consumers and serve as a bulwark against anti-competitive practices.

4. The Federal Reserve should extend its HOEPA rule to prohibit yield-spread premiums on subprime and nontraditional mortgages, and extend the protections provided for subprime to nontraditional loans.

In July of this year, the Federal Reserve Board (the Board) finally exercised its authority under HOEPA to prohibit unfair and deceptive practices. Its rule addresses some of the most destructive practices leading to this crisis by requiring, for subprime loans, lenders to evaluate a borrower's ability to repay; reining in abusive prepayment penalties on short-term subprime ARMs; and requiring escrowing for taxes and insurance. We commend Chairman Bernanke, the Board and the staff that worked on the rule for these actions. To help prevent further abusive lending, however, the Board must (i) address broker incentives to provide worse loans than borrowers qualify for by prohibiting abusive yield-spread premiums and (ii) extend protections provided for subprime loans to nontraditional mortgages as well.

5. Congress should pass the Homeownership Preservation and Protection Act (S 2452) sponsored by Senator Dodd and establish assignee liability.

As this Committee is aware, S 2452 would address many of the abuses discussed in this testimony by, among other provisions, (i) prohibiting steering prime borrowers into more expensive subprime loans; (ii) creating a duty for mortgage brokers to consider the best interests of their clients; (iii) providing for a duty of good faith and fair dealing toward borrowers for all lenders; (iv) extending the Board's ability to repay requirement to cover nontraditional loans; (v) prohibiting prepayment penalties and yield-spread premiums on all subprime and nontraditional loans; and (vi) allowing state attorneys general to enforce the provisions of the law and not overriding state laws. <u>Specific</u> and <u>enforceable</u> protections such as these are essential to protecting families' most important, and least protected, transaction.

Critically, the bill also takes important steps toward ensuring everyone has skin in the game all the way up the chain by providing for assignee liability. We have now learned beyond a shadow of a doubt that Wall Street will incent loan structures best for their short term profits, unrelated to long-term borrower interests, and that originators will supply the loans for which they are paid the most. It is also clear that regulators are not up to task of policing millions of thousands of loan originations.

The best way to re-align the interests of borrowers and lenders is for Congress to insist on meaningful assignee liability.[8] When assignee liability exists, the borrower is allowed to pursue legal claims against the assignee when the loan transaction involves illegal actions or abusive terms. In the case of the mortgage market, strong assignee liability would mean that when a trust purchases mortgages, with all the corresponding financial benefits, it also accepts reasonable liability for when the mortgages prove to be abusive and harm homeowners, and therefore the investors will pay a financial price.

Assignee liability can be tightly drawn but must satisfy the principle that an innocent borrower who has received an illegal loan must be able to defend that loan in foreclosure as compared with an equally innocent assignee. This is for two reasons: first, the assignee can spread this loss across thousands of other loans, while the borrower has but one home. Second, the assignee can choose who to buy their loans from; as a result, they can choose only reputable originators likely to make quality mortgages that are strong enough to purchase the loan back if it violates representations and warranties that the secondary market purchaser imposes.

Public enforcement can never be adequate: there is a shortage of resources to match against the millions of loans made to borrowers, and in some cases, a lack of will to take significant action. Investigations will inevitably be too slow for the homeowners who face foreclosure in the meantime, and while public enforcement can achieve some relief, it will rarely, if ever, be enough to make most individual borrowers whole. Assignee liability effectively uses the market to decentralize oversight of loans purchased—no one will better ensure that loans are originated to specified standards than investors who carry the associated financial and legal risk.

Assignee liability also helps to protect responsible investors from misperceived risks and provides incentives for the market to police itself, curbing market inefficiencies. And assignee liability is not a new concept; it exists in several other contexts related to lending.[9]

6. Additional legislative actions should be taken to induce loan modifications.

The following additional legislative actions should also be taken, either by modifying TARP or otherwise, to induce loan modifications:

Pursuant to TARP:

- ***Change rules governing trusts so that the government can purchase whole loans out of securities.*** The biggest problem with TARP with respect to loan modifications is that 80% of recent subprime and Alt A loans were securitized, and by purchasing securities, the government will own just a partial interest in the cash flow generated by loans, giving it no greater rights to modify loans than other owners scattered around the globe. If the government could buy whole loans, it would have the discretion to do modifications similar to what FDIC has done with IndyMac's portfolio. However, trusts are designed to be passive entities and are not permitted to sell whole loans, even though they have some flexibility to modify them or accept a refinance for less than the principal balance.

  Congress should pass legislation clarifying that participation in a government-sponsored whole loan purchase program would be permitted under Real Estate Mortgage Investment Conduit (REMIC) tax rules. Congress could further provide that continued REMIC status (and future tax benefits) is contingent on PSAs being modified to permit (but not require) participation in the loan sale process. Finally, Congress, the SEC or Financial Accounting Standards Board would need to ensure that accounting standards change to permit these sales. Clearly, having whole loans that servicers for whatever reason are unable to modify, that will cause needless foreclosures, and that Treasury cannot purchase even though it could restructure the loans to make them affordable to the borrowers and maximize the return to the government, is not socially optimal. There should be no objection freeing servicers to modify or sell these assets at the direction of a Treasury program.[10]

- ***Amend TARP to provide for meaningful protection for servicers when they modify loans.*** One obstacle to servicers in modifying loans is that they fear lawsuits by investors harmed by their decision; any modification will favor some investors and disfavor others. TARP attempts to deal with this problem by making clear that servicers owe their duty to investors as a whole, not to any particular class of investors who may be harmed by a modification. However, TARP includes the exception "Except as established in any contract." Congress should delete this phrase in order to provide servicers greater comfort.

Alternatively, Congress could enact a narrowly tailored indemnification provision for servicers who act reasonably in modifying or selling any loan under the Treasury program. Either change should increase servicers' willingness to modify in the face of particular investor objections.

Other legislative actions to induce modifications:

- ***Incent servicers to provide sustainable loan modifications.*** As a counterweight to the reality that most servicing contracts compensate servicers more for foreclosure than modification, Congress could fund a program to pay servicers up to, say, $1,500 for each modification that meets certain standards of effectiveness.

- ***Require servicers to engage in reasonable loss mitigation strategies.*** Congress should require that mortgage loan servicing companies pursue loss mitigation strategies in every instance prior to initiating foreclosures.

- ***Ensure income tax burdens do not undermine sustainability of loan modifications.*** Right now, when a servicer provides a homeowner with a loan modification containing a principal writedown (the type of writedown contemplated to occur under the new FHA Hope for Homeowners program), the IRS considers the homeowner to have received taxable cancellation of indebtedness income unless the mortgage debt is "qualified" under the terms of the Mortgage Forgiveness Debt Relief Act of 2007 or the homeowner is insolvent. In many instances, especially where the difference between the original loan amount and the current value of the house is large, the prospect of tax liability could discourage homeowners from participating in Hope for Homeowners or similar programs, or, if such a modification is obtained, resulting tax liability could cause the homeowner to redefault on the loan. To prevent this perverse result, Congress should amend the Mortgage Forgiveness Debt Relief Act of 2007 in two ways: (1) lenders should not be required to file Form 1099 with the IRS when cancelling any mortgage-related debt; and (2) the definition of "qualified mortgage debt" should be extended to include all mortgage debt, not just acquisition debt.

B. THINKING LONGER TERM: FUNDAMENTAL PRINCIPLES ESSENTIAL TO A PROPERLY FUNCTIONING MARKET

In addition to immediate actions needed to stem foreclosures, long-term systemic changes are also needed. The following three principles, essential to the long-term health of the mortgage market and the financial system as a whole, should serve as guideposts for longer-term reform: (1) sustainable mortgages based on sound underwriting; (2) alignment of market incentives (including assignee liability); and (3) adequate oversight. Further discussion of these principles is provided as Appendix B.

II. THE HOUSING BUBBLE AND UNSUSTAINABLE LENDING.

It is now widely accepted that we had a large housing bubble this decade. One of the primary reasons this bubble was created was a rapid rise in unsustainable subprime and Alt A lending—loans that borrowers could not manage for long, and that would lead inexorably to foreclosure in many cases unless housing kept appreciating indefinitely into the future, further disassociated from incomes. Now that the bubble has popped, these same mortgages, now proven unsustainable, are causing massive foreclosures. Meanwhile, voluntary modifications have not restructured unsustainable loans in nearly great enough numbers to stem the tide of foreclosures.

A. Unsustainable lending was a major cause of the housing bubble.

The recent run-up in housing prices ending in 2007 resulted in an 86% real increase in U.S. housing prices. Since past corrections have tended to erase most such cyclical growth, we are likely to experience a continuing decline in housing prices. To put this in perspective, through the end of the second quarter of this year, we have seen just a 25% contraction in real terms.

Even as housing prices were rising much faster than inflation, incomes were falling behind. From 2000 through year-end 2005, median real wages grew just 1.7%, while real housing prices grew 22%.[11] The combination of real housing price increases and flat or declining wages resulted in an unsustainable, and unstable, environment. And at a time when long-term interest rates were historically low—meaning that the best deal for borrowers would have been fixed rate loans—originators induced borrowers to take out "innovative" variations of adjustable rate mortgages that depressed payments in the early years of the loan—and kept the bubble growing.

Only 16% of subprime mortgages being securitized were relatively straightforward fixed-rate mortgages. In contrast, 40% were 30-year ARMs, 17% were interest-only loans, 19% were 40-year ARMs, and 8% were balloon loans.[12] From 2000 to 2005, the number of subprime loans made without full documentation of income climbed from 26% of subprime mortgages in 2000 to 44% in 2005,[13] while a staggering 9 out of 10 Alt-A option ARMs made in 2005 were without full documentation.[14] Failure to escrow for taxes and insurance was yet one more way families were fooled thinking they could afford what were in fact unsustainable loans—occurring mainly in the subprime market[15] and contributing to higher rates of foreclosure.[16]

When Federal regulators finally proposed to require lenders to underwrite loans to the fully-indexed, fully-amortizing payment schedule that would apply after expiration of initial rates, interest-only periods, and negative amortization, the response from industry was telling. In fact, at the time, Countrywide estimated that 70% of their recent borrowers would be unable to meet this common-sense standard.[17] Industry's response represented an admission that they had been making unsustainable loans that would eventually result in unaffordable payments.

For a more robust discussion of how unsustainable lending was a major cause of the housing bubble, including several related graphs, *see* Appendix A.

B. Unsustainable lending is causing needless foreclosures now that the bubble has popped.

Housing prices have reversed course; to date, prices have fallen approximately 20%, while many expect a further 15% fall. In April of this year, foreclosures over the next five years were projected at 6.5 million.[18] Using recent MBA data, we calculate that foreclosures, across all loans, are occurring at an annualized clip of 2.3 million, with subprime loans accounting for 1.2 million of those.[19] Either projection is beyond staggering. And the subprime meltdown has now sent the entire global economy into a tailspin, despite industry experts' repeated assurances that it wouldn't.[20]

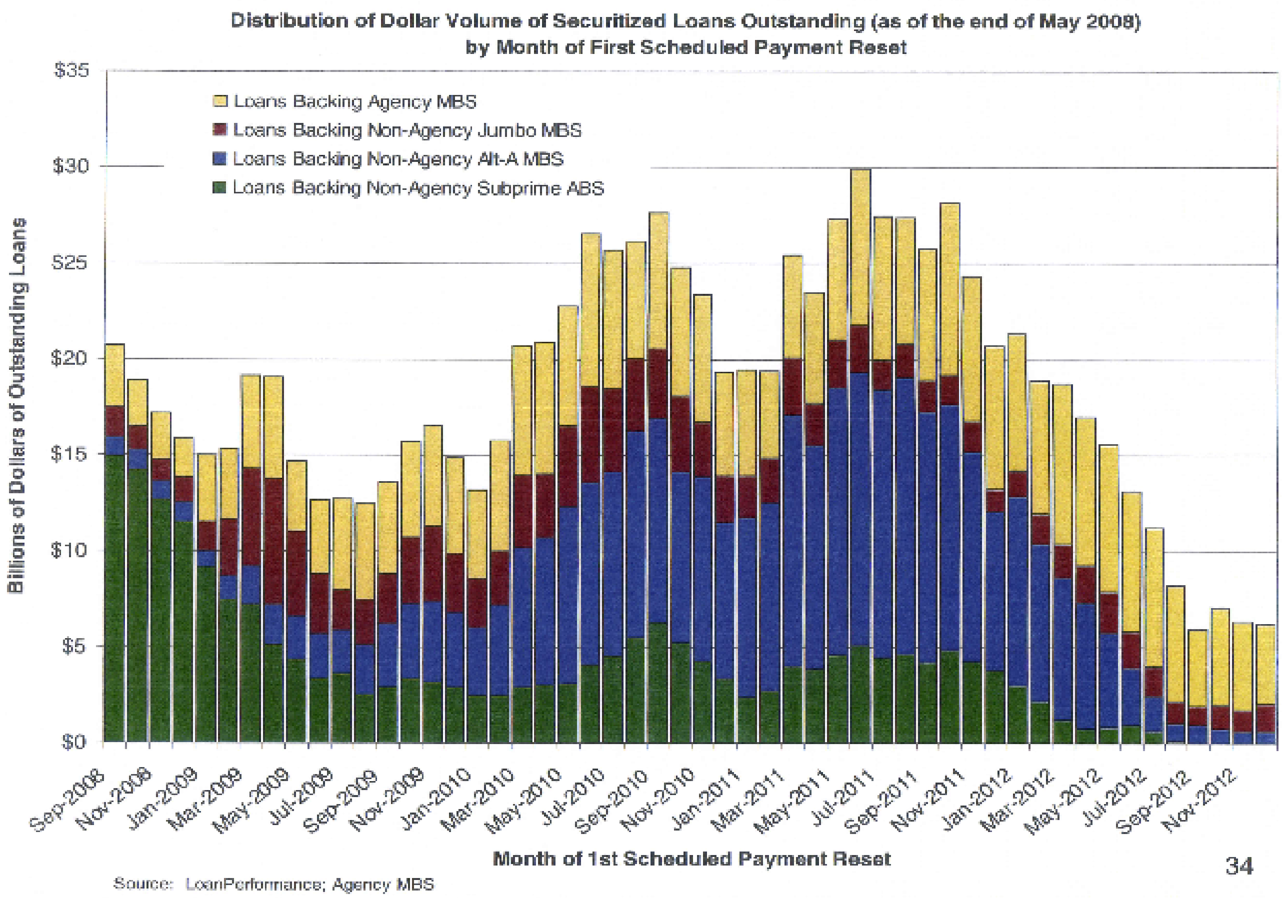
The bursting of this bubble is resulting in more foreclosures and a deeper financial crisis than it otherwise would have due to the very unsustainable mortgages that helped inflate the bubble in the first place. Millions of families now find that they cannot afford the payment upon expiration of an introductory period, nor can they refinance or sell their home because they are underwater on their mortgages and may, in addition, have been locked in by a prepayment penalty.

a. Families cannot afford the monthly payment upon expiration of an introductory period.

Introductory periods on both subprime and nontraditional loans are expiring in astounding numbers, and it's only projected to get worse. Principal loan value on securitized loans scheduled to reset in September 2008 was a little over $20 billion, including $15 billion of subprime and approximately $1 billion of Alt A. Subprime resets are scheduled to decrease steadily between now and mid-2009 and trickle to near zero by late 2010 (with a couple of upticks in mid 2010 and 2011), but since these loans are ARMs, every six months the rates on the loans will change, and resets will potentially rise if currently very low short-term indexes do.[21] And we haven't seen the tip of the Alt A iceberg. Total scheduled resets skyrocket in 2010 and 2011, reaching about $27.5 billion in late 2010 and peaking at $30 billion in mid-2011. Approximately half of that $30 billion is attributable to Alt A.

See Figure 1 on the following page.

Figure 1: Resets of Securitized Loans Outstanding as of May 2008



Perhaps most reckless of all abusive practices was the pervasive failure to assess ability to repay, particularly upon the inevitable increase in the original monthly payment—i.e., the payment shock. Payment shocks are created by a variety of dangerous loan structures: loans made without documenting incomes because the families simply did not afford the payment; subprime exploding ARMs where the payment increases by 30% - 40% after the second year, even if rates in the economy stay constant; interest-only loans where the payment can increase by 50% when the loan starts amortizing over a shorter remaining life; and payment option ARMs where the payment can double when it recasts at the fifth year, for lenders who require recasting at that time rather than ten years out. If they were not well underwritten at the fully indexed, fully amortizing payment when made, as many lenders failed to do, *they set the borrowers up for failure*.[22]

b. Families cannot sell or refinance because they are under water on their mortgages.

Recent reports estimate close to one in six homeowners now owe more on their mortgage than their home is worth, and almost one in three who bought their home in the last five years are in the same predicament.[23] Borrowers who are under water on their mortgage, statistically, default in much greater numbers than those who are not, largely because the safety nets of selling the house or refinancing the mortgage are no longer available when an income shock occurs through either reduced family income or higher expenses.[24] Tragically, the income shortages that ultimately lead to default are often created by the pressure on income created by the unsustainable mortgages fueling the bubble.

Further, many families that might have escaped their mortgage by refinancing before housing values became prohibitively low found themselves trapped by a prepayment penalty. Commonplace in the subprime market, a prepayment penalty on a $250,000 loan could be expected to be in the range of $4,000-$5,000—enough to prevent or discourage refinancing. Independent research has fixed the increased risk of default on subprime mortgages with prepayment penalties from 16-20% over already high baseline rates.[25]

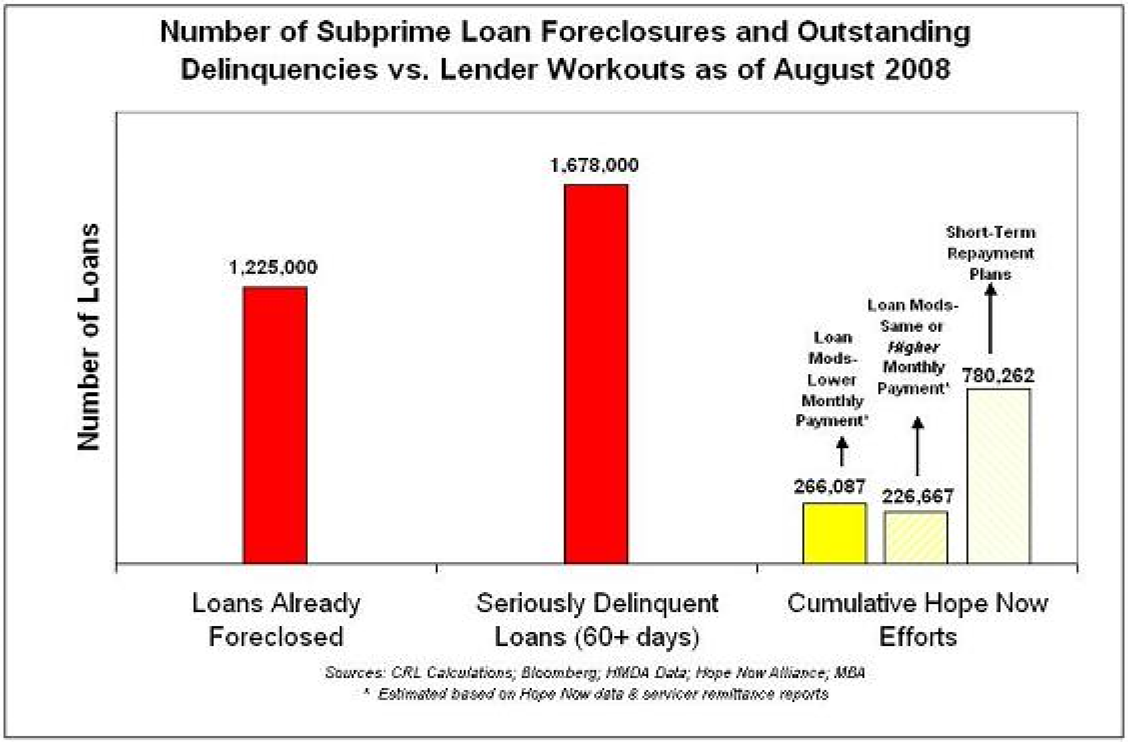
Even families who aren't holding abusive loans are finding themselves indirect victims of them. They, too, are increasingly under water on their mortgages due to the tremendous spillover effect of neighboring foreclosures. CRL's latest estimates project that 40.6 million homes neighboring subprime foreclosures will experience a property devaluation averaging $8,667 each as a result of the foreclosures, amounting to a total decline in house values and tax base from nearby foreclosures of $352 billion.[26] These families' lost equity and resulting inability to refinance or sell is contributing to the rise in foreclosures.

C. Voluntary loan modifications are not stopping the foreclosures.

Despite the loss mitigation encouragement by HOPE NOW, the federal banking agencies, and state agencies, voluntary efforts by lenders, servicers and investors have failed to stem the tide of foreclosures. Seriously delinquent loans are at a record high for both subprime and prime loans,[27] and according to most the most recent HOPE NOW data, foreclosure starts continue to outpace total loss mitigation efforts.[28]

See Figure 2 on the following page.

Figure 2: Number of Subprime Loan Foreclosures and Outstanding Delinquencies vs. Lender Workouts as of August 2008



The most recent report from the State Foreclosure Working Group (covers 13 servicers, 57% of the subprime market, and 4.6 million subprime loans) finds servicer modification progress to be "profoundly disappointing." Their data indicates that nearly eight out of ten seriously delinquent homeowners are not on track for any loss mitigation outcome, up from seven out of ten from their last report. An increasingly small number of homeowners are on track for loss mitigation, and even the homeowners who get some kind of loss mitigation actions are increasingly losing their house through a short sale or deed-in-lieu rather than keeping the home through a loan modification or workout.[29]

Neither the Housing and Economic Recovery Act of 2008 (HERA) nor the Emergency Economic Stabilization Act of 2008 (EESA) requires more than voluntary modifications. HERA creates an expanded FHA program that will help facilitate refinancing of troubled mortgages, but use of that program is voluntary and left entirely up to individual lenders and servicers. EESA, the legislation that permits the Treasury to buy troubled assets, also relies on Treasury voluntarily working with servicers to modify the loans that it buys.

There are a number of reasons why voluntary loss mitigation cannot keep up with demand. One reason is that the way servicers are compensated by lenders often creates a bias for moving forward with foreclosure rather than engaging in foreclosure prevention. As reported in *Inside B&C Lending*, "Servicers are generally dis-incented to do loan modifications because they don't get paid for them but they do get paid for foreclosures."[30] Even when a loan modification would better serve investors and homeowners, some loan servicers have an economic incentive to proceed as quickly as possible to foreclosure.

But even those servicers who want to engage in effective loss mitigation face other structural obstacles. One major obstacle is the number of homes that have more than one mortgage or lien against the home. Between one-third and one-half of the homes purchased in 2006 with subprime mortgages have second mortgages,[31] and many more homeowners have open home equity lines of credit secured by their home. The holder of the first mortgage will not generally want to provide modifications that would simply free up homeowner resources to make payments on a formerly worthless junior lien, nor to modify a loan where there is a second mortgage in default. But as Credit Suisse reports, "it is often difficult, if not impossible, to force a second-lien holder to take the pain prior to a first-lien holder when it comes to modifications," thereby dooming the effort.[32]

Another structural obstacle is posed by securitization. When servicing securitized loans, servicers are bound by the terms of the pooling and servicing agreement (PSA), which may limit what they can do by way of modification. For example, some PSAs limit the number or percentage of loans in a pool that can be modified.[33] Moreover, even if the PSA is not a problem, most modifications will disproportionately harm one set of investors (or one tranche of the security) because of how the stream of income is carved up; for example, a change in interest rate may impact different investors than a waiver of a prepayment penalty. Servicers may shy away from modifications fearing investor lawsuits.

It is also important to note the gap between rhetoric and reality about how easy it is to get a loan modification.[34] Servicers often excuse the paucity of loan modifications by claiming that their efforts to modify loans are stymied by homeowners' refusal to respond to servicers' calls and letters. While this no doubt happens, counselors report that the bigger problem is the reverse. We repeatedly hear from homeowners and housing counselors that the numerous homeowners who actively reach out to their servicers face the same problem: despite repeated calls to the servicer and many hours of effort, they cannot get anyone on the phone with the authority or ability to help. Many professional housing counselors are demoralized by the servicers' practice of incessantly bouncing the caller around from one "on hold" line to another, such that desperate homeowners never reach a live person or one with decision-making authority.

What's more, when modifications and other workouts are made, they are frequently temporary or unsustainable, leading to re-default and placing homeowners in an even worse economic position than when they started. More than a year ago, leading lenders and servicers publicly and unanimously endorsed a set of principles announced at the Homeownership Preservation Summit hosted by Chairman Dodd, which called upon servicers to modify loans to "ensure that the loan is sustainable for the life of the loan, rather than, for example, deferring the reset period."[35] Unfortunately, we now see very high rates of redefault on loan modifications, primarily because most loan modifications or workouts do not fundamentally change the unsustainable terms of the mortgage by reducing the principal or lowering the interest rate, but instead just add fees and interest to the loan balance and amortize them into the loan, add them to the end of the loan term, or provide a temporary forbearance.[36] According to Credit Suisse, when interest rates or principal are reduced, the redefault rate is less than half of those for more traditional modifications.[37]

Finally, in many cases, voluntary loan modifications or workouts are placing distressed homeowners at a further disadvantage because the servicer forces homeowners to waive all their rights in exchange, even those unrelated to the workout.

III. WHO'S TO BLAME?

A. Wall Street

1. Investors and Issuers

Wall Street's appetite for risky mortgages encouraged lax underwriting and the aggressive marketing of unaffordable loans.[38] As investors searched for ever-higher yields, Wall Street bankers thought they had found a sure-fire way to meet that demand: take subprime (risky) mortgages, bundle them into a pool, and sell off pieces of the pool—different streams of income from the mortgage loans—as securities. Ratings agencies, who were paid by the investment firms marketing these securities only when the securities were issued and sold, obligingly gave AAA ratings to the top 80% or so of the pools. Then, to bootstrap the lower-rated tranches, some of those too were repooled, sliced, and marketed magically as AAA, through collateralized debt obligations (CDOs). All of this activity took place outside the firms' balance sheets, while the size of the asset-backed securities market rose from $73 billion in 2000 to $628 billion in 2006.[39]

As long as housing prices continued to rise, the underlying quality of the mortgages was of no particular interest to the investment firms. Bonuses depended on short-term revenue, which trumped any incentives to worry about what would happen if the market changed. 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."[40]

Wall Street investment banks became addicted to the fee income that subprime and Alt A securitizations provided. Among them, Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley took in an estimated $7.6 billion in revenues from selling and trading mortgage-backed securities in 2006—including $1.75 billion in revenues related to subprime mortgage-backed securities.[41] In addition, many became addicted to the interest income provided by highly leveraged—$30 of debt to $1 of capital—investments in these securities, investments that were fatally dependent on rolling over short-term funding.[42]

2. Rating Agencies

The investment banks and subprime lenders who gamed the system and did massive harm to homeowners and the economy could not have done so without the aid and comfort of bond rating firms. With Wall Street and federal regulators abdicating their responsibilities, the ratings industry became "the de facto watchdog over the mortgage industry."[43] As Roger Lowenstein, one of the nation's most respected financial journalists, put it in the *New York Times Magazine* this spring, Moody's, Standard & Poor's and Fitch in a practical sense set the credit standards for the loans that Wall Street could bundle into securities and, by extension, which borrowers could qualify for these loans.

But there was a problem: Because they were paid by investment banks hungry for more product to package into securities deals, the rating agencies had a strong incentive to turn a blind eye and go easy on the lenders and their Wall Street allies.[44] Rating agencies could reap $200,000 or more in fees on a single complicated mortgage-backed securities deal.[45] Moody's saw its earnings nearly triple from 2002 to 2006, largely due to high profits on structured finance deals.[46] Former SEC chair Arthur Levitt has said that the rating agencies' conflict of interest "may have distorted their judgment . . . when it came to complex structured financial products." Lowenstein has called the rating agencies "a central culprit in the mortgage bust."

Instead of requiring that lenders and investment bank use common-sense standards for verifying borrowers' ability to afford their loans, the rating agencies helped foster a Wild West mentality in which unsafe loan products and predatory sales tactics became commonplace. Investors—and the world financial markets—trusted the rating agencies because of their long history and the gloss of prudence that came with their special status in the financial system. That trust, we now have learned, was misplaced.

B. Originators

The market Wall Street created didn't just tolerate riskier mortgages, it preferred them. Not surprisingly, originators provided what the market was paying the most for. Subprime mortgages generated much higher profit margins than prime mortgages. According to the New York Times, profit margins at Countrywide just before the bust were 2% for subprime, versus 0.82% from prime mortgages, and in 2004, subprime loans were producing gains of 3.64% versus 0.93% for prime loans.[47]

Market participants readily admit that they were motivated by the increased fees offered by Wall Street in return for riskier 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?"[48]

Loan originators—particularly independent mortgage brokers—specialized in steering customers to higher-rate loans than those for which they qualified, particularly minority borrowers. They also loaded up the loans with risky features, including prepayment penalties, and encouraged borrowers to take out so-called “no doc” loans even when those borrowers had easy access to their W-2s.

A key driver of the upselling is a practice known as yield-spread premiums (YSPs), in which lenders pay independent brokers special bonuses if they place a customer into a higher-rate loan than that for which the customer qualifies. Generally, the maximum bonus also required the broker to sell the borrower a prepayment penalty to lock in the higher rate. Like other broker fees, the YSPs would be paid to the broker upon settlement of the loan, at which point the broker would have no further interest in the performance of that loan.[49]

This upselling resulted in a huge percentage of borrowers paying more for their loans than they should have. For example, the Wall Street Journal reported on a study that found 61% of subprime loans originated in 2006 “went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms.”[50] Even applicants who did not qualify for prime loans could have received sustainable, thirty-year, fixed-rate loans for—at most—half to eight tenths of a percent above the initial rate on the unsustainable exploding ARM loans they were given.[51] Indeed, many homebuyers were charged 1% more for “no-doc” loans when they had already handed over their W-2 statements or readily would have done so but for the originator’s desire to make these riskier loans.[52] As a result, the typical risky adjustable rate subprime loan was more expensive than far safer thirty-year fixed-rate loans *even at the initial payment.*

Independent brokers played a particularly destructive role in the subprime market. CRL released a study earlier this year showing that brokered loans, when compared to direct lender loans, cost subprime borrowers additional interest payments ranging from $17,000 to $43,000 per $100,000 borrowed over the scheduled life of the loan. Even over a fairly typical four-year loan term, the subprime consumer pays over $5,000 more for brokered loans.[53] One explanation for this disparity is that brokers are often viewed by prospective homeowners as trusted agents shopping on their behalf for the cheapest loan. Yet brokers largely have no explicit fiduciary duty to borrowers,[54] leaving only their own economic self-interest to fulfill. Many brokers mislead borrowers or engaged in outright fraud.[55]

Countrywide paid both its brokers and its own loan officers more for unaffordable products. Broker commissions were up to 2.5% for Countrywide’s poorly underwritten payment-option ARMs and 1.88% for subprime loans compared with 1.48% for standard fixed rate mortgages.[56] While much of the abuse can be traced to brokers, compensation for retail loan officers was made in a similar way.[57]

The practices of IndyMac, one of the largest originators of Alt-A loans until it went defunct, demonstrate that perverse incentives drove abuse outside of the subprime market.[58] IndyMac routinely avoided including income information on their loans or pushed through loans with inflated income data, even from retirees.[59] As recently as the first quarter of 2007, only 21% of IndyMac’s total loan production involved “full-doc” mortgages.[60]

Most loan originators understood that they were putting borrowers into loans that were unsustainable and that would need to be refinanced prior to reset. In 2004, the General Counsel of New Century, then the nation's second-largest subprime lender, referred to its 2/28 interest-only product and stated that: " . . . . we should not be making loans to borrowers with the expectation that the borrower will be able to refi in a couple years."[61] His warning was ignored, however, despite being a member of senior management and, according to the examiner of the company in bankruptcy, "certainly [having] influence within the company."[62]

C. Regulators

While providers of capital paid originators of loans handsomely to foist unsustainable mortgages on families, the regulators were largely asleep at the switch. The crisis we are now in is largely the result of the breakdown of this nation's regulatory system. The agencies responsible for protecting depositors, shareholders, taxpayers, borrowers and the general financial system failed. They stood by as predatory practices and dicey lending became commonplace, ravaging the mortgage market and setting off a chain reaction of financial devastation. Regulators relied on the belief that all lending is good lending, and ignored the fact that if government does not make sure that families are getting affordable loans, it cannot protect the lenders or the broader financial system either.

1. The Federal Reserve failed to effectively use its authority under HOEPA.

Fourteen years ago, Congress required the Federal Reserve Board (the Board) to prohibit mortgage lending acts and practices for all originators that are abusive, unfair or deceptive, but the Board took no action until July of this year—even though borrowers, state regulators, and advocates repeatedly raised concerns about abuses in the subprime market, and hard evidence demonstrated the destructive results of abusive practices.[63]

Eight years ago, House Banking Committee Chairman Jim Leach said to the Board:

> [C]ongress . . . passed a law which was very strong in its sense of purpose in outlawing predatory lending, in effect, and then because Congress felt that the subtleties of this were beyond Congress, we gave the Federal regulators, most specifically the Federal Reserve Board of the United States, the authority to make definitions and to move in this direction . . . . So the question becomes, if there is a problem out there, if Congress has given very strong authority to regulators and the Federal Reserve, or regulators, is the Federal Reserve, our regulators, is the Federal Reserve AWOL?[64]

At that time, we also urged the Board to use its unfair and deceptive practices authority under HOEPA to prohibit abusive practices such as prepayment penalties on mortgages with interest rates greater than conventional rates.[65] While the Fed was failing to act, dozens of states passed their own regulations to address abusive practices.[66]

As noted earlier, in July of this year, the Board finally exercised its authority to prohibit unfair and deceptive practices by issuing a strong rule with respect to subprime loans. We commend Chairman Bernanke and the Board for this big step forward while noting that had these rules been issued just three years earlier, countless foreclosures could have been prevented. And still left for another day are broker incentives to provide worse loans than borrowers qualify for through yield-spread premiums and abusive practices on nontraditional loans.

2. Regulators failed to regulate investment banks and credit default swaps.

In 2004, the Securities and Exchange Commission (SEC) exempted the brokerage units of the five largest investment banks from its leverage requirements.[67] The freed-up capital allowed the banks' parent companies to invest in mortgage-backed securities, credit default swaps, and other exotic mortgage-related products. Leverage ratios soared. In exchange for the relaxed regulation, the investment banks offered to allow the SEC to examine their books, creating a system of voluntary oversight for five institutions whose assets in 2007 totaled $4 trillion.

Unfortunately, as SEC Chairman Christopher Cox has recently admitted, "The last six months have made it abundantly clear that voluntary regulation does not work."[68] What's more, the SEC did not use the authority it did have. A recent SEC Inspector General report notes that the SEC's division of trading and markets "became aware of numerous potential red flags prior to Bear Stearns's collapse, regarding its concentration of mortgage securities, high leverage, shortcomings of risk management in mortgage-backed securities and lack of compliance with the spirit of certain [capital standards]," but it "did not take actions to limit these risk factors."[69]

Failure to regulate credit default swaps was a key factor enabling the subprime securities market to grow as large as it did.[70] Instead of labeling these transactions as insurance— which would have required the retention of sufficient capital to cover defaults—regulators allowed them to be characterized as over-the-counter and unregulated swaps. Moreover, the $60 trillion credit default swaps market[71] encouraged speculation, since investors could purchase the insurance without purchasing the security. When housing prices fell and rendered the securities worthless, the insurers—like AIG—lacked sufficient capital, by a long shot, to cover all the defaults.

3. The OCC was focused on preempting stronger state laws.

The Office of the Comptroller of the Currency (OCC) also played a key role in the mortgage meltdown, both by actively blocking state consumer protection laws through the expansion of federal preemption, and by simultaneously failing to adequately monitor the nationally-chartered lending institutions under its purview.

Since the late 1990s when anti-predatory lending laws were enacted by several states to provide substantive protections for consumers and place responsible checks on mortgage lending, the OCC worked to expand the reach of its powers and preempt state laws.[72] The laws that the OCC worked to displace were not only designed to protect homeowners, but to preserve a safe, well-functioning market.

Several actions taken by the OCC under former Comptroller John D. Hawke, Jr. are particularly noteworthy for their likely consequences. First, in 2002, Georgia passed comprehensive mortgage reform legislation, which included assignee liability. Upon request of National City Bank and its subsidiaries, including subprime lender First Franklin Financial, the OCC pronounced the Georgia law preempted in its entirety, and followed by proposing expansive new preemption rules.[73] Bolstered by the OCC action, subsequent efforts led to the gutting of the Georgia law. According to former head of the Office of Thrift Supervision, Ellen Seidman, had the law remained on the books, it could have served as a model for other states, and may have reversed the course of reckless lending earlier in the game.[74]

In 2003, State Attorneys General concerned about the rise of increasingly risky and abusive loans met with Hawke to request more leeway for the states to confront the problem.[75] Comptroller Hawke reportedly stood his ground on preemption, however. As the former North Carolina Attorney General saw it, "[The OCC] took 50 sheriffs off the job during the time the mortgage lending industry was becoming the Wild West."[76] Repeatedly, state officials who sought to rein in reckless lending practices "were thwarted in many cases by Washington officials hostile to regulation and a financial industry adept at exploiting this ideology."[77]

While the OCC is quick to place the blame on states for failing to regulate the entities under state control, the OCC's stringent preemption policies had a double whammy effect. Not only did they block strong regulation of federally-chartered entities, the immunity of federal entities prompted arguments from state-chartered entities that strong state reforms would create an "uneven playing field" in which they could not compete. These arguments served to chill action by state policymakers, and the result was a level playing field—on a field with no rules.

Unfortunately, while the OCC thwarted state efforts, it also ignored evidence of predatory lending within national banks and their affiliates and subsidiaries, simply repeating the mantra that there was no predatory lending in the national banks.[78] Only one of the 495 OCC enforcement actions against national banks from 2000 through 2006 involved subprime mortgage lending.[79]

As early as 2003, however, CRL highlighted to the OCC the evidence and/or allegations of predatory lending among national banks and their subsidiaries such as Guaranty National Bank of Tallahassee,[80] Wells Fargo, and First Franklin.[81] As we witness the record-breaking losses among the national banks from their exposure to subprime and other risky mortgages, there is no longer any question that federally-chartered banks and their lending arms engaged in risky and often predatory lending. Merrill Lynch, which purchased First Franklin from National City, had to shut the unit down after its $1.3 billion purchase became essentially worthless, and has seen total losses exceeding $50 billion.[82] Large national banks have reported combined losses of $100 billion from their subprime exposure.[83]

We commend Comptroller Dugan and the OCC for helping to lead the other federal agencies in issuing the Interagency Guidance on Nontraditional Mortgage Product Risks in late 2006 and the Statement on Subprime Mortgage Lending in June 2007. Such guidance, however, underscores the failed oversight by the OCC prior to this time that I just described. As one example, Countrywide booked $161 billion in payment option ARM loans while it was under the watch of the OCC, but ***86% of those loans could not meet the interagency guidelines***.[84] Some predict that given the lack of underwriting and risky features, as many as 45-50% of POARM loans that were current at recast, will eventually end in default.[85]

The unfortunate truth is that if the OCC had spent more time performing its duties of oversight rather than attempting to make its charter the most appealing, it could have played an important role in averting this crisis.

4. The OTS utterly failed in its oversight responsibilities.

All federal banking regulatory agencies must share in the blame for the mortgage debacle, but the Office of Thrift Supervision stands out for its record of failure. The collapse of three institutions under OTS's watch—NetBank, IndyMac and Washington Mutual—constitute case studies of regulatory ineptitude.

An inspector general's report in the wake of the September 2007 failure of NetBank concluded that OTS ignored clear warning signs about the bank's risky lending.[86] The Inspector General found OTS "did not react in a timely and forceful manner" to "repeated indications of problems in NetBank's operations"—problems that had been evident for years in OTS examinations.[87]

Yet NetBank's failure was simply a prelude to the downfalls of IndyMac and Washington Mutual. Never before in American history have two banks so large failed within months of each other. IndyMac's failure is the fourth largest bank failure in American history. WaMu's collapse was the largest ever.[88] OTS failed to take effective action to halt the unsafe and unfair lending practices that eventually doomed both. And even as it became clear that these two banks' loan performance and financial returns were rapidly taking a turn for the worse, OTS failed to act aggressively to alleviate the damage. In fact, OTS prevented FDIC from taking timely action by declining to put the two banks on the government's list of troubled banks until just before they went under—far too late to make any difference.

Had OTS looked with a skeptical eye, it wouldn't have been hard for the agency to find signs IndyMac was engaging in high-risk activities. This was made clear by the large percentage of poorly underwritten mortgage products that made up IndyMac's loan portfolio—low- and no-documentation loans that required little or no verification as to borrowers' ability to repay. The result was a growing list of consumers stuck in predatory loans that endangered their homes.

IndyMac's customers included people like Simeon Ferguson, an 86-year-old retired chef living in Brooklyn, N.Y. Mr. Ferguson was suffering from dementia at the time he got a loan from IndyMac. A lawsuit filed on Mr. Ferguson's behalf claims a mortgage broker used the false promise of a 1% interest loan to steer Mr. Ferguson into an IndyMac "stated income" loan program for retirees. IndyMac made no effort to verify retirees' income, attempting to duck accountability "by deliberately remaining ignorant of the borrower's ability to pay the mortgage," the lawsuit says. IndyMac's instructions for preparing the mortgage application required that "the file must not contain any documents that reference income or assets."[89]

The damage to borrowers and other citizens would have been reduced if OTS had forced IndyMac to pull back as the housing and mortgage markets slowed in 2006. Instead, IndyMac continued to push aggressively for more growth, increasing its loan volume by some 50% in 2006, during a year when overall industry volume fell slightly. As a growing number of loans went bad, OTS failed to identify the danger that IndyMac faced—despite the fact that measures of the bank's financial health first showed significant signs of trouble in mid-2007, and indicated accelerating deterioration in the fall of 2007.[90]

In the end, IndyMac's demise cost thousands of bank employees their jobs. Large numbers of customers with uninsured deposits will get only a fraction of their savings back. And the failure is expected to cost the Federal Deposit Insurance Fund nearly $9 billion.[91]

It appears the story was much the same with Washington Mutual as it was with IndyMac. WaMu grew its volume of subprime lending from $19.9 billion in 2003 to $36 billion in 2005. One example of WaMu's less-than-sterling lending record has been highlighted by Mike Shedlock, an economic analyst who's been tracking a bundle of more than $500 million in loans that WaMu packaged into a mortgage-backed securities pool in May 2007. The borrowers didn't appear to be bad risks; their average FICO score topped 700, indicating they had solid credit histories. But barely 10% of the loans in the pool were made with full documentation of borrowers' ability to repay. One year into its life, 23% of the pool was already in foreclosure or in repossession.[92]

An ABC News investigation cites dozens of former employees who say WaMu's management brushed aside and in some cases fired risk management gatekeepers who warned that the bank was steering down a dangerous path. "Everything was refocused on loan volume, loan volume, loan volume," a former senior risk manager told ABC, adding that on several occasions higher-ups pressured him to upgrade his risk assessment in order to make a loan deal go through. Another former employee said that mortgage underwriters were instructed not to question whether or not a loan should be approved, but to simply check whether certain lending procedures had been followed.[93]

State authorities in New York, meanwhile, are pressing a case that accuses WaMu of systematic fraud in its appraisal process. In November 2007, New York state Attorney General Andrew Cuomo sued one of the nation's largest appraisal companies, claiming that the firm had caved into the pressure from WaMu to use only appraisers who were willing to "bring in the values" that WaMu's loan sales staff demanded.[94] Cuomo said that WaMu had "strong-armed" the appraisal firm into allowing the bank to hand-pick appraisers willing to inflate home values and help questionable loans go through, as part of "a system designed to rip off homeowners and investors alike."[95] In all, the appraisal firm did more than 260,000 appraisals for WaMu between the spring of 2006 and the fall of 2007, earning $50 million in fees.

In short, WaMu and IndyMac were not guileless victims of financial hurricanes they had no control over, and the OTS had readily available information about what was going on, yet declined to intervene.

As we noted in above, we believe OTS should be merged into a unitary regulator that has a much stronger focus on consumer protection and bank safety.

5. **HUD should not have provided affordable housing goals credit for Fannie Mae's and Freddie Mac's purchase of subprime securities.**

In order to ensure that Fannie Mae and Freddie Mac serve the interests of families of modest means, Congress delegated to HUD the authority to set affordable housing goals for the GSEs. While both GSEs adopted standards on loans they would purchase, these standards were not applied to securities in which they invested. The GSEs purchased securities of loans that violated the standards until 2007 when Freddie Mac first voluntarily agreed to stop[96] and the Office of Federal Housing Enterprise Oversight (OFHEO) later ordered both GSEs to stop.[97]

Back in 2000, we started arguing that Fannie and Freddie should not receive goals credit for investing in securities backed by abusive loans.[98] Numerous other groups argued the same point in comments to HUD during the 2000 and 2004 goals setting processes.[99] However, HUD failed to open the door to consider what abusive loans should not be permitted to count under the goals or permitted to be purchased at all.

6. **Federal regulators' failure is especially clear in light of States' efforts.**

In recent years, when the federal government failed to act, a number of states moved forward to pass laws that address abusive practices. The leadership shown by states helped to encourage the adoption of best practices by responsible lenders and leaders in the mortgage industry. Research assessing these laws has shown them to be successful in cutting excessive costs for consumers without hindering access to credit.[100] And other states benefited as well. Spearheaded by active states such as North Carolina and Iowa (among others), the states Attorneys General pursued enforcement actions and settlements against some of the larger institutions that employed widespread abusive practices. These settlements held bad actors accountable for their actions, brought relief to borrowers and influenced the marketplace nationwide.

States could not do the job alone, however. Industry vigorously opposed state efforts and thwarted many of them. In fact, even good state bills did not prevent foreclosure crises in those states. A major problem was that state bills often did not capture the largest mortgage finance companies making many of the most irresponsible loans. The Board, on the other hand, had the authority to reach *all* market actors and could *extend* common sense practices and model protections provided by many states on a macro basis. Sadly, a popular argument that kept some states from enacting more stringent laws was only available because of lax federal regulations: that protective state laws would place state-chartered lenders at a competitive disadvantage, while federally chartered entities could operate under more relaxed federal standards.

IV. <u>WHAT DIDN'T CAUSE THE CRISIS</u>

A. COMMUNITY REINVESTMENT ACT

In an attempt to divert attention away from the destructive lending practices and lack of government supervision that fueled the credit crisis, some are trying to place the blame for it on the Community Reinvestment Act (CRA). They argue that CRA forced lenders to make risky loans to low- and moderate-income families and to communities of color.

Nothing could be farther from the truth. Lenders made riskier, higher interest rate loans because they were the most profitable ones in the short-term, generating huge fees and bonuses for participants up and down the chain—brokers, lenders, securitizers and investors. On their list of priorities, sustainability fell a distant second to profitability.

CRA, on the other hand, has led to affordable, sustainable loans in underserved communities. Consider these facts:

- CRA was in effect long before the subprime market existed. CRA was passed in 1977 to correct the longstanding problem of redlining—the lack of lending in low and moderate income communities and in communities of color. CRA has been on the books for three decades, while the lending practices that created this crisis didn't exist until the past five years.[101]

- Most subprime lenders weren't covered under CRA. The predominant players in the subprime market—mortgage brokers, mortgage companies and the Wall Street investment banks that provided the financing—aren't covered under CRA.[102] In fact, in 2004 and 2005, at the height of the subprime boom, the two biggest subprime lenders alone, Ameriquest and New Century, accounted for approximately 22% of all subprime loan volume.[103] They drove the market; all others followed; both were non-bank lenders not covered by CRA. Finance company affiliates of major banks participated heavily in subprime lending, but are only included in CRA to the extent their bank parents choose them to be. In fact, many banks shifted the most risky lending—the loans at the root cause of this current crisis—to affiliates to escape CRA requirements and regulatory oversight.

- CRA-covered banks made safer loans than institutions not covered under CRA. A recent study found that CRA-covered banks were less likely than other lenders to make a high-cost loan; the average APR on their high cost loans were lower than those originated by non-covered lenders; and they were more likely than other lenders to retain originated loans in their portfolio (indicating that they had the incentive to make affordable loans).[104] In addition, foreclosure rates were lower in Metropolitan Statistical Areas with greater concentrations of bank branches.[105]

- Wall Street created the demand for riskier loans. As Newsweek stated, "Investment banks created a demand for subprime loans . . . . and made subprime loans for the same reason they made other loans: They could get paid for making the loans, for turning them into securities, and for trading them—frequently using borrowed capital", not because of CRA.[106]

- The majority of subprime loans went to white borrowers. While it is true that African-American and Latino families disproportionately received ruinous subprime loans, the majority of total loans were made to non-Latino white families. According to data from

> the Home Mortgage Disclosure Act (HMDA) from 2005-2007, 58% of higher-cost loans went to white borrowers, with 18% to African-American borrowers and Latino borrowers each.

As *Newsweek* aptly concluded, "Lending money to poor people doesn't make you poor. Lending money poorly to rich people does."[107] The answer to this financial crisis is not to cut off access to credit in underserved communities. Homeownership still represents the best way for low and moderate income families to build wealth—we shouldn't abandon that goal because of subprime lenders' bad decisions.

B. HOMEOWNERS WHO ARE NOW ON THE VERGE OF LOSING THEIR HOMES

During the height of subprime lending, industry often defended questionable lending practices by saying that the subprime market was a key part of building homeownership. Since the market has fallen, the story line has shifted, and now one of the myths that has been widely circulated is that typical recipients of subprime loans were greedy, low-income and minority borrowers, who foolishly took out home loans they could ill afford to buy expensive homes. However, the facts belie this stereotype, and show that too often lenders steered customers to loans described as "unfair" and "deceptive" by Federal Reserve Chairman Ben Bernanke. In fact, when issuing new lending rules in July 2008, the Fed's preamble to the rules included this comment:

> "Consumers in the subprime market face serious constraints on their ability to protect themselves from abusive or unaffordable loans, even with the best disclosures; originators themselves may at times lack sufficient market incentives to ensure loans they originate are affordable; and regulators face limits on their ability to oversee a fragmented subprime market."[108]

While subprime lenders claimed that these risky loans made homeownership a reality for borrowers who would not otherwise qualify for conventional loans, the *Wall Street Journal* has reported a different story. According to the *Journal*, the majority of borrowers at the height of the subprime lending in 2005 and 2006 could have qualified for lower-cost conventional mortgages. By 2006, 61% of subprime mortgages went to borrowers with credit that would have qualified them for conventional loans.[109] Further, those who needed subprime loans often qualified for thirty-year fixed rate loans but were steered into exploding ARMs at higher rates with worse terms.

In addition, 90% of subprime mortgages made were to borrowers who already owned their own homes.[110] Sixty percent were refinances, and 30% were for families who were moving from one home to another.[111] These dangerous loans in fact caused a net reduction in homeownership.

Although some like to portray distressed homeowners as people who took out loans to cover sprawling McMansions, data collected under the Home Mortgage Disclosure Act show this isn't the case: The most recent information collected under the Home Mortgage Disclosure Act shows that the average subprime loan amount was only $205,700.[112]

Lenders are professional risk managers, and will always know more than borrowers. Yet John Robbins, the former Chairman of the Mortgage Bankers Association, described the deceptive loans made by his industry as "extremely risky" and the lenders who made them as more focused on money and commissions than on customers.[113]

As we consider how this market has operated in recent years, it is important to remember the impact on ordinary, hard-working people all over the country. As one illustration, consider the plight of Candace Weaver, an eighth grade teacher in North Carolina. Mrs. Weaver refinanced her mortgage in 2005 to pay bills that had accumulated after her husband had a heart attack and was out of work. She received an adjustable-rate mortgage that started at 8.85% but then after two years went to 11.375%, and was set to go as high as 15.85%. Mrs. Weaver was never offered a fixed-rate loan, and she didn't understand her rate could change.

Six months after getting the mortgage, Mrs. Weaver was diagnosed with kidney cancer. Even before she had surgery, she called her loan servicer to try to work something out because she anticipated having a hard time keeping up payments. However, the servicer refused to help until she was actually in default, and then they offered her an expensive plan to avert foreclosure. Mrs. Weaver managed to pay $7,000 over six weeks, but she fell behind again, and the foreclosure proceedings that had been put on hold resumed. This stress, in addition to her health problems, has placed an enormous strain on the Weaver family. The upshot is that an abusive loan has severely undermined the Weavers' financial security, and may ultimately rob them of their home.

C. FANNIE MAE and FREDDIE MAC

The current crisis has laid bare the dangers of our government's failure to rein in industry's excesses and safeguard against inappropriate lending practices. In response, opponents of efforts to impose such safeguards on industry have begun a high profile campaign to insist that such safeguards are not needed for the loan originators who made the blatantly unsustainable loans, the Wall Street firms who bought the loans and securitized them, or the investors who purchased the securities. Instead, they claim that the blame lies with Fannie Mae and Freddie Mac because the GSEs also purchased some of these securities. According to this claim, Fannie Mae and Freddie Mac alone should have been subject to greater regulation that precluded them from buying these securities, but the other parties that made, securitized and invested in these loans should be left alone. The claim is further made that it was government mandates that required Fannie and Freddie to purchase loans to low-income families that caused large taxpayer losses.

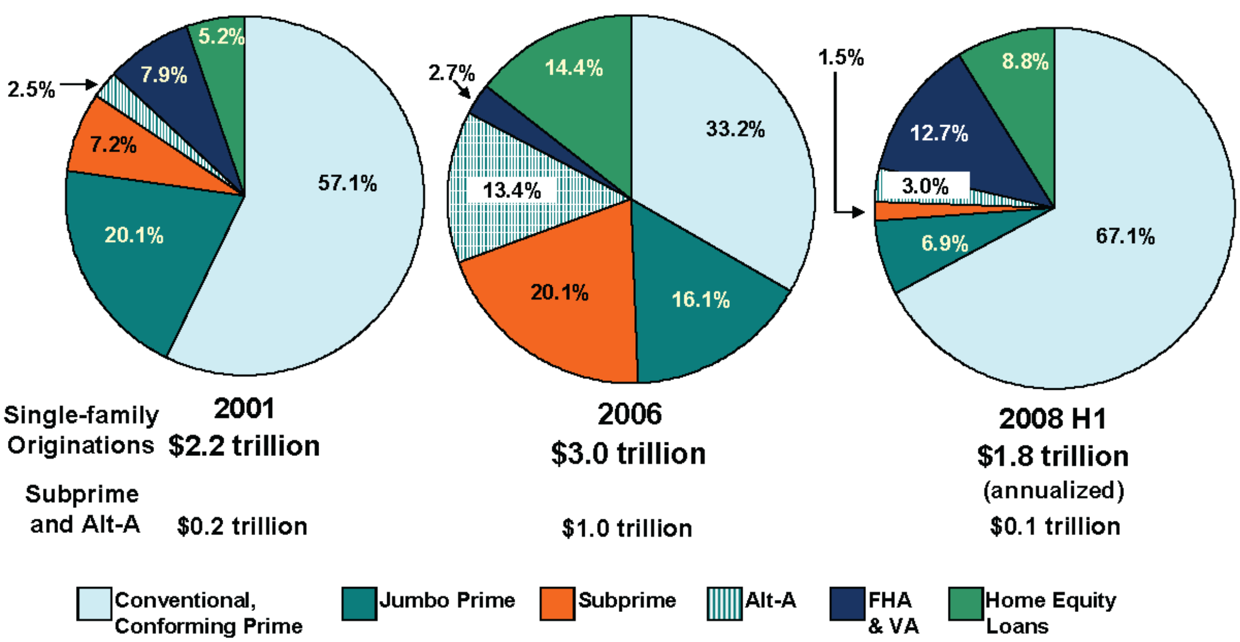
Fannie Mae and Freddie Mac publish lending guidelines that set minimum standards for the loans they buy. The loans that drove the present crisis, subprime loans, did not meet these standards, and the GSEs thus did not buy them directly.[114] For this reason, the purchase and securitization of these substandard loans was done exclusively by Wall Street firms.

Fannie Mae and Freddie Mac did, however, purchase a substantial number of these "private label" mortgage backed securities (that is, securities created by Wall Street), particularly early in subprime's development; we have severely criticized this fact, including in testimony to this Committee.[115] Instead of denouncing these inappropriate Wall Street practices, the GSEs joined the bandwagon for these investments. To its credit, in February 2007, Freddie Mac suspended its purchase of mortgage backed securities based on loans that did not consider the borrower's ability to repay based on the higher expected rate that would occur after two years of a subprime hybrid ARM.[116]

Fannie Mae and Freddie Mac also eventually followed Wall Street into the purchase of Alt-A loans, typically without documentation of borrower income. These poorly underwritten, risky loans have produced substantial losses for the GSEs, as they have for Wall Street, although GSE Alt A loans have performed much better than privately securitized loans.

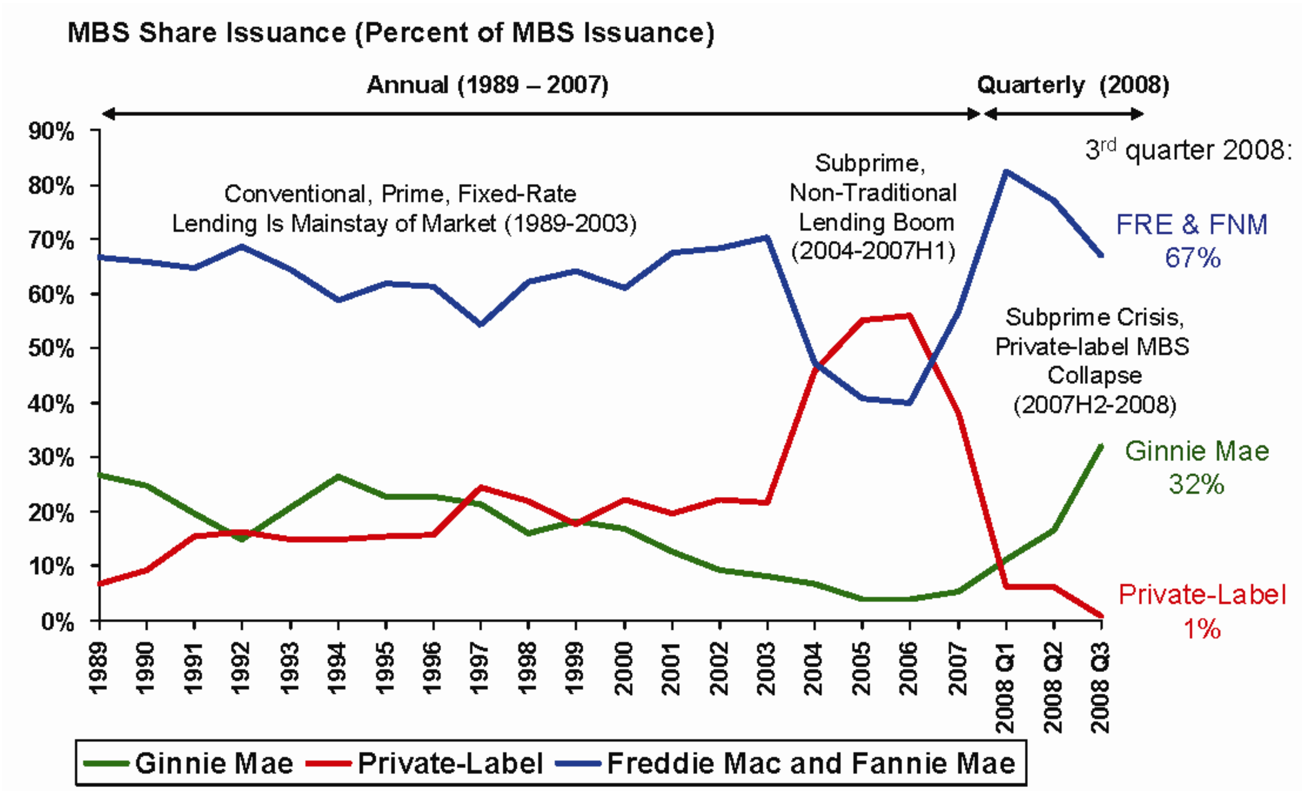
Nevertheless, it would be wrong to assign the GSEs the leading role in the subprime crisis. First, the GSEs' role in the mortgage market diminished substantially as subprime lending rose. As of 2001, Fannie Mae and Freddie Mac funded almost two-thirds of home mortgage loans across the United States. These were loans that Fannie Mae and Freddie Mac purchased directly from originators who met the GSEs' guidelines and either held on their balance sheets or securitized and sold to investors. In contrast, subprime loans accounted for just 7% of the market. This began to change around 2003, when the GSEs were largely displaced by private issuers who were beginning to introduce new, riskier loan products into the market.[117] In early 2004, private-issue MBS surpassed the GSE issuances of all loans, and by early 2006, Fannie and Freddie's market share of new issuances had *dropped* to one-third of the total. At the same time that the role of the GSEs was declining, the percentage of loans in the mortgage market that was subprime almost *tripled*, as shown in Figures 3 and 4 below.[118]

Figure 3: Subprime and Alt-A Volume Quintupled 2001 to 2006, Then Fell in 2007 to 2008



Source: Frank E. Nothaft, Chief Economist, Freddie Mac, Presentation prepared for Milken Institute's Financial Innovations Lab on Housing: Beyond the Crisis, Oct. 7, 2008, p. 1 (citing Inside Mortgage Finance, by dollar amount).

Figure 4: MBS Share Issuance (Percent of MBS Issuance) 1998-present



Source: Frank E. Nothaft, Chief Economist, Freddie Mac, Presentation prepared for Milken Institute's Financial Innovations Lab on Housing: Beyond the Crisis, Oct. 7, 2008, p. 1 (citing Inside Mortgage Finance, by dollar amount).

Second, the GSEs' purchase of private label subprime securities was dwarfed by the purchases made by hedge funds, Wall Street firms and other private investors. During the first nine months of 2006, the GSEs bought 25% of the private label subprime mortgage-backed securities sold, and their purchases were limited to the AAA tranches.[119] Other investors purchased the other 75%, including 100% of the subordinate securities. It is worth noting too that the AAA tranches were the least risky and therefore most readily marketable securities. Thus, the GSEs were not creating a market for unsellable securities; to the contrary: had the GSEs not bought them, numerous other investors were eager to do so.

Similarly insupportable is the claim that the GSEs' financial woes resulted from the GSEs' HUD-mandated affordable housing goals. It is true that Fannie Mae and Freddie Mac received affordable housing goals credit for the purchase of subprime securities, although it is likely that higher yields were the major motivation. But subprime loans are not the cause of the GSEs' financial problems. Currently Freddie Mac has \$85 billion and Fannie Mae \$28 billion of subprime securities on their balance sheets.[120] These securities are subordinated by approximately 20%, which means that the GSEs will not lose principal unless approximately 40% of the borrowers lose their homes to foreclosure. While this may occur, their losses will be relatively modest due to the senior position they hold. Freddie Mac has impaired this portfolio by $500 million.[121] Fannie Mae holds $8 billion of whole subprime loans that it purchased, but these have caused just 2.2% of its second quarter losses.[122]

The source of both GSEs' losses, and the reason they are no longer independent, are not these subprime loans to low-wealth borrowers, but rather the Alt A loans that the GSEs purchased that were made to relatively wealthier borrowers. Critiques of Fannie and Freddie tend to conflate the earlier subprime securities purchases and their later jump into purchasing higher-income loans where lenders did not document borrower income.

The Alt A epidemic was in full flower by the time that the GSEs got into the act; see Figure 3 above. In 2004, Angelo Mozilo, then chief executive at Countrywide, reportedly demanded that Fannie Mae buy the lender's riskier loans, or else they couldn't purchase its less risky loans.[123] "You're becoming irrelevant. You need us more than we need you, and if you don't take these loans, you'll find you can lose much more," Mozilo reportedly said, and at the time, his assertion would have been hard to dispute.[124] Fannie Mae and Freddie Mac started buying Alt A loans in significant numbers. From 2005 to 2007, Fannie bought three times as many loans without the usual documentation of income or savings as it had in all earlier years combined.[125]

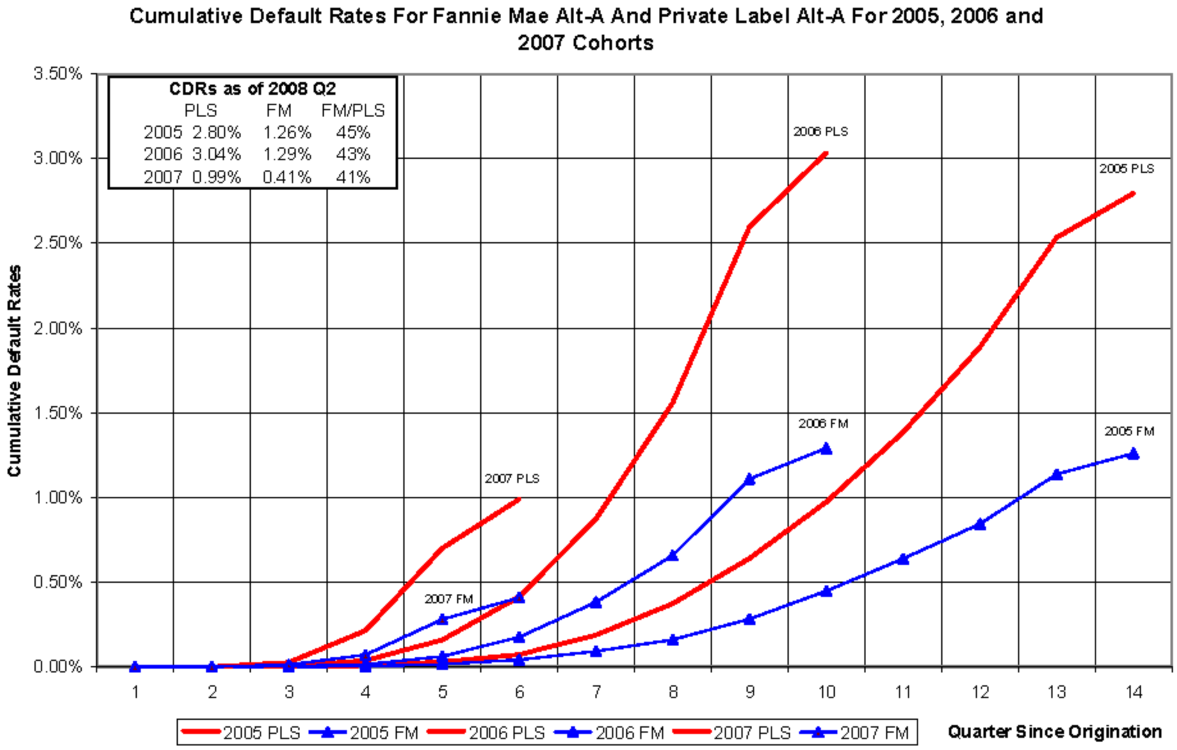
By the middle of this year, Alt A loans account for roughly 10% of Fannie and Freddie's risk exposure, but a whopping 50% of their combined losses.[126] Losses on Freddie Mac's Alt A loans have accounted for 79% of the increase in total credit losses (from $528 million to $810 million) between the first and second quarters of 2008.[127]

While the move into Alt A mortgages was ill advised, it was not driven by affordable housing goals pressure. Alt A mortgages are generally high balance, higher income, high credit score loans that are classified as Alt A because they do not document income or assets.[128] Given their income characteristics, they actually *dilute* the GSEs' affordable housing ratios, yet these are the loans that are causing the GSEs' losses.

Moreover, as ill advised as the GSEs' Alt A exposure was, the Alt A activities of Wall Street were even worse. As shown in Figures 5 and 6 below, the credit characteristics of Wall Street's private label Alt A mortgage backed securities were far riskier than those of Fannie Mae's Alt A loans, and, for this reason, Wall Street's losses on Alt A loans were much higher.

See Figures 5 and 6 on the following page.

Figures 5 and 6: Fannie Mae Alt A Loans Versus Loans Underlying Private-Label Alt A Securities



Note: The last data point on each curve is as of April 30, 2008. Private label security data is from Loan Performance.

Fannie Mae Alt-A Loans Versus Private Label Security Conforming Alt-A		
	Fannie Mae Alt-A	PLS Market Alt-A
	As of April 2008	Outstanding loans backing non-agency Conforming Alt-A MBS as of April 2008
FICO	719	709
OLTV	73%	76%
CLTV at Origination	77%	82%
Product Type		
Fixed Rate	71%	43%
Adjustable Rate	29%	57%
Interest Only	21%	26%
Negatively Amortiz	3%	25%
Investor	17%	21%

Source: Fannie Mae Q2 10-Q Investor Summary (Aug. 8, 2008).[129]

The final point to make regarding the GSEs is that although they contributed to the subprime market, and they made wrongheaded investments in loans that did not document income, they were a lifeline for the economy when the Wall Street-driven asset-backed securities market dried up in 2007 because of excessive mortgage-related losses; see Figure 4 above. And as demonstrated in Figure 3 above, by 2008, the GSEs and FHA provided liquidity for virtually all conforming sized loans in the country. If the GSEs had not stepped in when they did, the credit crunch that we are facing would be infinitely worse, as would the current recession. Further, as we can attest through our long-standing partnership with Fannie Mae, their investment in sustainable loans in low-income and low-wealth communities has substantially improved the lives of hundreds of thousands of American families.

Unfortunately, those who have been calling for greater regulation of the GSEs have not been calling for the reining in of abusive lending practices, or the securitization practices that enable them. This is because for the most part, these advocates are themselves frequently industry players who want a bigger share of this market for themselves. For this reason, they urge the abolition of these practices for the GSEs alone, while urging that the rest of the industry have free reign to continue them. Other advocates of abolishing these practices by the GSEs are those rightfully concerned about the risk to taxpayer dollars being taken by the GSEs. While reining them in would have saved taxpayer losses (although none have occurred to date, and we can hope they do not), which is very important, it would not have averted the financial crisis; it would simply have distributed more of the losses to private firms. As we now see, these Wall Street firms' losses can become the taxpayers' problem as well.

In any event, all homeowners pay the price for the irresponsible lending practices of recent years. To rein these in for the GSEs, while ignoring the greater and more widespread abuses of the rest of the market, would do nothing to prevent similar crises from occurring again.

CONCLUSION

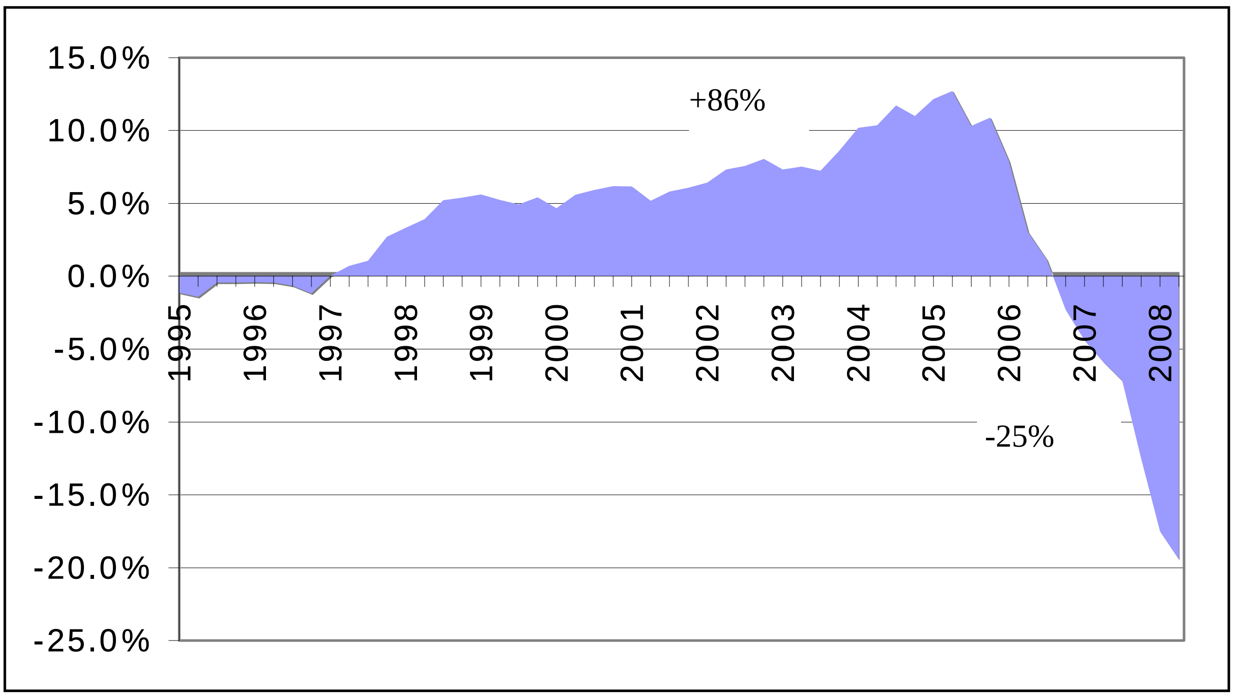
Today's financial crisis is a monument to destructive lending practices—bad lending that never before has been practiced on such a large scale, and with so little oversight. Unfortunately, the entire country is paying the price. There is no single solution to the challenges facing us today, but any effective policies must seek to maximize the number of people who stay in their homes. In particular, Congress should lift the ban on judicial restructuring of loans on primary residences, Treasury should ramp up its efforts to do FDIC-like streamlined modifications, Congress should merge OTS into OCC, the Federal Reserve should extend its HOEPA rules and Congress should pass the Dodd anti-predatory lending bill.

APPENDIX A

UNSUSTAINABLE LENDING WAS A MAJOR CAUSE OF THE HOUSING BUBBLE.

The recent run-up in housing prices ending in 2007 resulted in an 86% real increase in U.S. housing prices. Past corrections have tended to erase most such cyclical growth. To put this in perspective, through the end of the second quarter of 2008, we have seen just a 25% contraction in real terms.

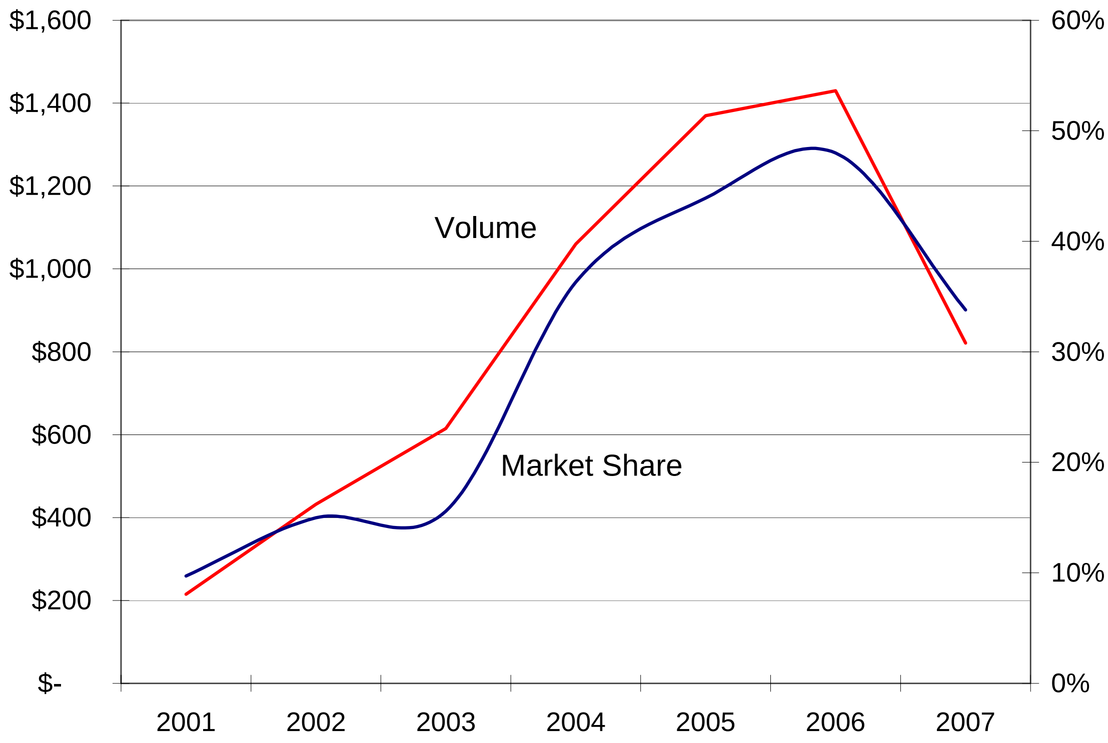
Figure 7: Inflation-Adjusted Annual Change in U.S. Housing Prices with Cyclical Totals



Sources: Standard & Poor's S&P Case-Shiller Home Price Indices, BLS

Even as housing prices were rising much faster than inflation, incomes were falling behind. From 2000 through year-end 2005, median real wages grew just 1.7%, while real housing prices grew 22%.[130] The combination of real housing price increases and flat or declining wages resulted in an unsustainable—and unstable—environment. Amounts borrowed grew dramatically relative to incomes over recent years; the sharp increase from 2001 through the end of the period coincides with dramatic increase in subprime and Alt-A lending. Figure 8 shows that by 2006, subprime, Alt-A, and home equity lending more generally had reached a near-majority (48%) of total volume loaned that year.

Figure 8: Total Subprime, Alt-A, and Home Equity Volume in Billions and Share of Mortgage Origination Volume, by Year

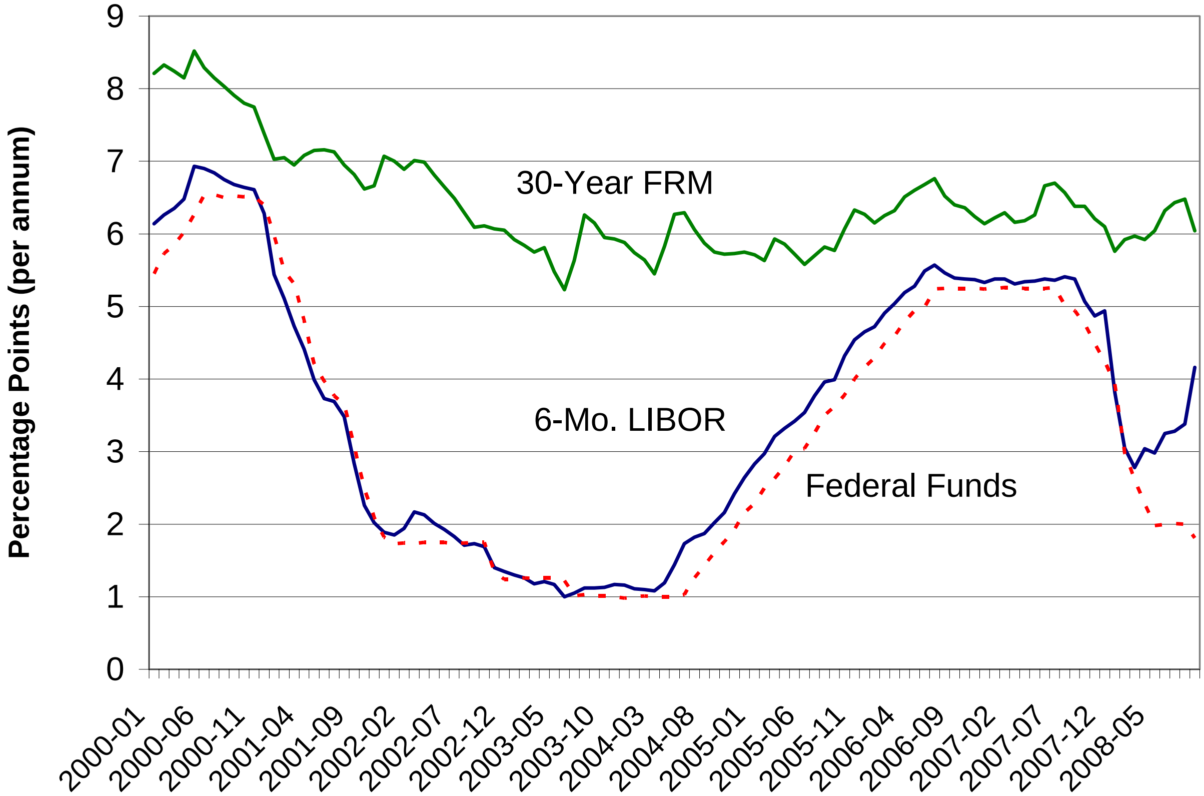


Source: IMF Publications[131]

At a time when long-term interest rates were historically low—meaning that the best deal for borrowers would have been fixed rate loans—originators induced borrowers to take out "innovative" variations of adjustable rate mortgages that depressed payments in the early years of the loan and induced payment shock later on.

Figure 9 displays the rates on 30-year fixed-rate mortgages and the LIBOR index commonly used to price subprime adjustable-rate mortgages and the Federal funds rate, all of which reached 30-year lows in the period covered. These low rates translated into smaller monthly payments and obscured the true cost of mortgages for many families, particularly with ARMs.

Figure 9: Interest Rates Dip to Historic Lows



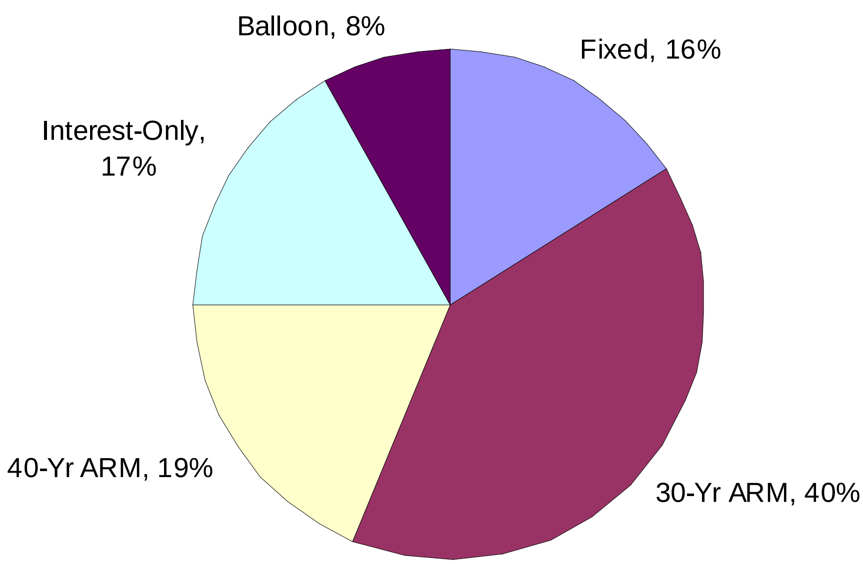
The unsustainable nature of loans was masked by these mortgage "innovations" that obscured the true cost of mortgage credit and eschewed time-tested underwriting standards to approve as many loans as possible—introductory rates bound to rise, interest-only loans and payment option ARMs for families for whom this product was not appropriate; low and no doc loans; and a departure from escrow for taxes and insurance.

a. "Innovative" loan features: "teaser" rate ARMs, interest-only loans, payment option ARMs.

A switch to mortgages with introductory rates that were bound to rise allowed families to defer repayment of principal or to pay less than the amount of interest owed on the loan, while these products were not suitable for families who could not afford the fully amortizing rate. Though introductory rates expire, families that raised such concerns were routinely counseled that they would be able to refinance or sell their home later. Even for those whose misgivings continued, the flawed perception that the mortgage market was heavily regulated and the pressure to buy a home to avoid the threat that homeownership would become permanently unaffordable were powerful salves. In fact, the strategy of financing mortgages with unaffordable mortgages worked for at least a few years as rapidly increasing property values supported subsequent refinancing into loans with a new introductory rate. However, embedded in each of these mortgages was a rate or payment waiting to explode when property values ceased their upward march.

By 2006, Figure 10 shows that just 16% of subprime mortgages being securitized were relatively straightforward fixed-rate mortgages. In contrast, 40% were 30-year ARMs, 17% were interest-only loans, 19% were 40-year ARMs, and 8% were balloon loans. These factors permitted more families for whom the mortgages were not ultimately sustainable to qualify.

Figure 10: Traits of Securitized Subprime Mortgages from 2006



Source: Chaudhary[132]

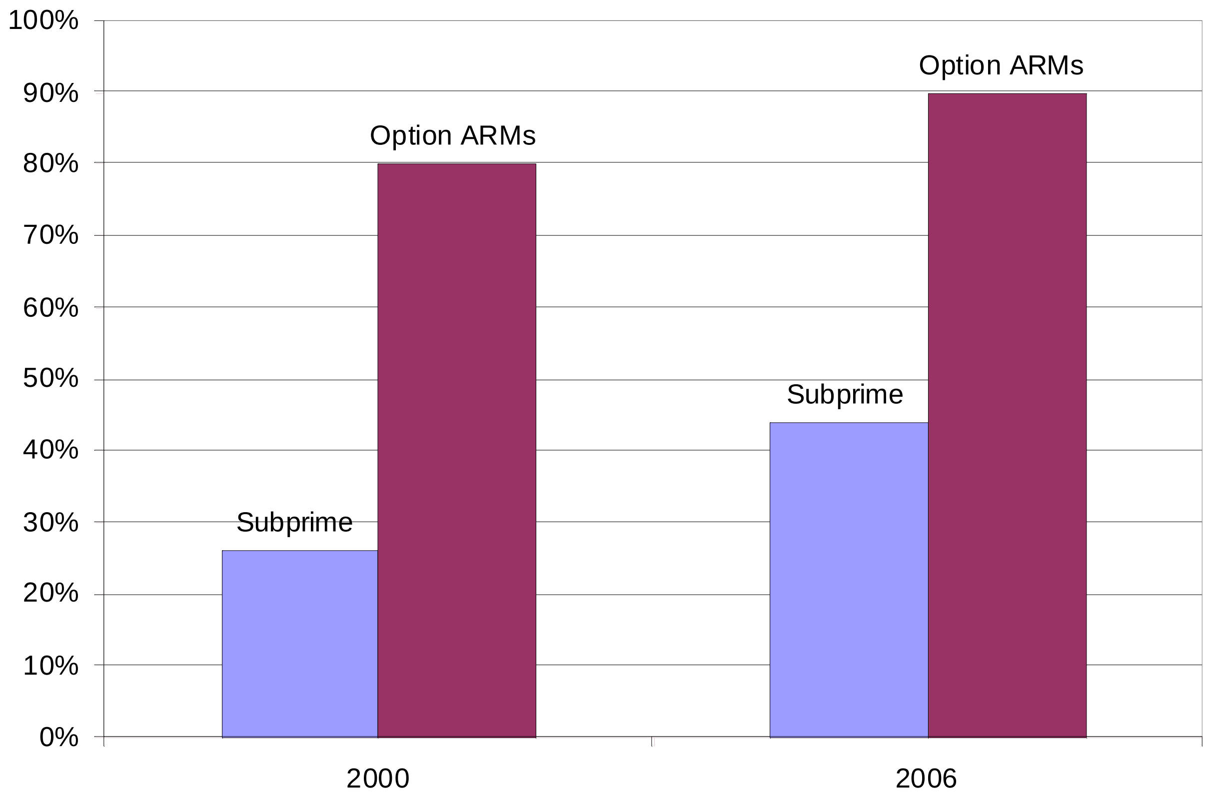
The shift to adjustable-rate mortgages among weaker borrowers was particularly unfortunate: The difference between a fixed-rate and an adjustable subprime mortgage at origination was commonly half to eight tenths of a percentage point.[133] In fact, given the very high margin over the short term loan index associated with subprime ARMs following expiration of the initial rate, subprime ARM borrowers who stayed in their mortgage more than two and a half years would be slated to pay more for their mortgage than those who took out subprime fixed rate.

When Federal regulators finally proposed to require lenders to underwrite loans to the fully-indexed, fully-amortizing payment schedule that would apply after expiration of initial rates, interest-only periods, and negative amortization, the response from industry was telling. In fact, at the time, Countrywide estimated that 70% of their recent borrowers would be unable to meet this common-sense standard.[134] Industry's response represented an admission that they had been making unsustainable loans that would eventually result in unaffordable payments.

b. Low and no doc loans

Exaggerating borrower income is another way to sell borrowers mortgages they can't sustain. Within the troubled subprime sector, a near-majority of loans were made without full documentation of income. As Figures 11 shows, this was a strong trend, climbing from 26% of subprime mortgages in 2000 to 44% in 2005.[135] Alt-A option ARMs, particularly among recent entrants in making these loans, had an even greater incidence of loans with less than full-documentation, particularly the newer entrants providing this loan type: by 2006, 9 of 10 such loans were made without full documentation up from the already high mark of 1 in 5 in 2000. Other types of Alt A loans were similarly skimpy on documentation of income or assets.[136]

Figure 11: No- and Low-Documentation Loans 2000 and 2006, by segment



Sources: Li and Ernst, Fitch Ratings[137]

c. Failure to escrow for taxes and insurance

Failure to escrow for taxes and insurance was yet one more way to fool families into thinking they could afford mortgages they couldn't afford. The failure to escrow occurred mainly in the subprime market[138] and has contributed to higher rates of foreclosure.[139] By creating artificially low monthly payment figures, the failure to escrow deceived borrowers about the actual cost of these mortgages relative to those offered by competitors that do escrow.[140] It also put families in the position of facing an unexpected tax bill, and made them targets for new high-cost refinancings. Moreover, homeowners who did not escrow were much more likely to be subjected to the unnecessarily high cost of force-placed insurance.[141] Because lenders could generate significant fees from force-placing insurance, the lack of an escrow requirement provided an opportunity for them to increase their revenue.

APPENDIX B

FUNDAMENTAL PRINCIPLES
ESSENTIAL TO A PROPERLY FUNCTIONING MARKET

I. SUSTAINABLE MORTGAGES BASED ON SOUND UNDERWRITING

In many respects, the risky mortgages of recent years appear modern, advanced, and complicated. In reality, these unsustainable mortgages marked a big step backward—a return to mortgages prevalent before the Great Depression, that required borrowers to get a new loan when it expired and, therefore, housing appreciation. These loans were five-year balloon loans, which are antecedents to the 2/28 exploding subprime ARM, or poorly underwritten nontraditional mortgages that build in substantial payment shock.

We can find useful guidance in the successful solution implemented at that time. The Home Owners' Loan Corporation (HOLC) was established in 1933 to help distressed families avoid foreclosure by buying mortgages at a discount from the banks that held them, and restructuring five-year, often non-amortizing loans into loans that borrowers could afford and sustain—15-year, amortizing loans at a fixed maximum interest rate of 5%.[142] This massive intervention had extraordinary impact, ameliorating a housing crisis in which almost half of all mortgages were in default.[143]

The Federal Housing Administration and Fannie Mae, and later Freddie Mac, were established to facilitate widespread provision of the type of long-term, fixed-rate, sustainable loans that HOLC provided. All require 30-year terms, principal amortization, documentation of income, and escrow of taxes and insurance—the responsible loan features and underwriting practices that have been abandoned by so many in recent years.

We must return to a system of sustainable mortgages based on sound underwriting practices:

- Ability to repay, the fundamental tenant of mortgage lending, must be assessed, taking the following into account:
    - The debt-to-income measure must be at a reasonable level, should take into account all debt payments, including principal, interest, taxes and insurance, any other mortgages, and other household debt.
    - There should be an assessment of residual income to ensure that there are adequate resources available to cover family living expenses after deducting debt service requirements from monthly income.
    - Documentation is crucial, and verification should be made based on W-2 and 1099 forms, tax records, bank records, and/or other reasonable third-party documents.

- The use of loan-to-value ratios is inappropriate in the ability to repay context, because it does not relate to a borrower's monthly income.

- Prepayment penalties should be banned on all subprime and nontraditional loans;

- Escrow of taxes and insurance should be required for all subprime and nontraditional loans.

The Federal Reserve's recent HOEPA rules are a significant step in the right direction. However, they do not address ability to repay, prepayment penalties, or the need to escrow on nontraditional loans, leaving a critical gap in the regulatory framework.

II. ALIGNMENT OF INCENTIVES

FDIC Chairman Sheila Bair recently noted, referring to the separation of origination, funding and servicing segments in the securitization model: "If we want private securitization to ever work again, we need a workable compensation scheme that aligns the interests of all the players in the game."[144] In short, there must be skin in the game all the way up the chain. Assignee liability, elimination of abusive yield-spread premiums, prohibition of prepayment penalties and high fees on subprime and nontraditional loans, enforceable originator duties, and requiring that investors pay rating agencies instead of issuers are essential changes needed to ensure healthy alignment of incentives in the market.

A. Assignee liability

We have now learned beyond a shadow of a doubt that Wall Street will incent loan structures best for their short term profits, unrelated to long-term borrower interests, and that originators will supply the loans for which they are paid the most. It is also clear that regulators are not up to task of policing millions of thousands of loan originations.

The best way to re-align the interests of borrowers and lenders is for Congress to insist on meaningful assignee liability.[145] When assignee liability exists, the borrower is allowed to pursue legal claims against the assignee when the loan transaction involves illegal actions or abusive terms. In the case of the mortgage market, strong assignee liability would mean that when a trust purchases mortgages, with all the corresponding financial benefits, it also accepts reasonable liability for when the mortgages prove to be abusive and harm homeowners, and therefore the investors will pay a financial price.

Assignee liability can be tightly drawn but must satisfy the principle that an innocent borrower who has received an illegal loan must be able to defend that loan in foreclosure as compared with an equally innocent assignee. This is for two reasons: first, the assignee can spread this loss across thousands of other loans, while the borrower has but one home. Second, the assignee can choose who to buy their loans from; as a result, they can choose only reputable originators likely to make quality mortgages that are strong enough to purchase the loan back if it violates representations warranties that the secondary market purchaser imposes.

Public enforcement can never be adequate: there is a shortage of resources to match against the millions of loans made to borrowers, and in some cases, a lack of will to take significant action. Investigations will inevitably be too slow for the homeowners who face foreclosure in the meantime, and while public enforcement can achieve some relief, it will rarely, if ever, be enough to make most individual borrowers whole. Assignee liability effectively uses the market to decentralize oversight of loans purchased—no one will better ensure that loans are originated to specified standards than investors who carry the associated financial and legal risk.

Assignee liability also helps to protect responsible investors from misperceived risks and provides incentives for the market to police itself, curbing market inefficiencies. And assignee liability is not a new concept; it exists in several other contexts related to lending.[146]

B. Prohibition of prepayment penalties and high loan fees on subprime and nontraditional loans.

Prepayment penalties and high loan fees reward originators that produce abusive subprime and nontraditional loans by paying them handsomely regardless of the long-term sustainability of the loan. To eliminate the disastrous effects of such perverse incentives, they should be banned on these loans.

C. Prohibition of abusive yield-spread premiums

We discuss earlier in this testimony the perverse incentives driven by abusive yield-spread premiums—one of the most reprehensible practices in the subprime mortgage market, yet one the Board's recent final HOEPA rule did not address. Banning yield-spread premiums would significantly reduce incentives for brokers to upsell borrowers into more expensive and riskier loans than those for which they qualify. Absent a ban on yield-spread premiums, any payment of such a premium by a lender should be recognized as a per se acknowledgment of agency between the broker and originating lender, with liability for the broker's acts and omissions irrebuttably attaching to the originating lender and subsequent holders of the note.

D. Duties

Clarifying the duty of care that originators have toward their borrowers is a critical step in promoting sustainable loans that serve both homeowners and investors as well as communities and neighbors. Brokers hold themselves out as trusted guides to borrowers, and they should be held to this standard. Brokers should be deemed to owe a fiduciary duty, including loyalty, avoidance of conflicts of interest between themselves and the homeowners, and use of reasonable care in pursuing the borrowers' interests. If duty standards applied only to brokers, then brokers may avoid special broker rules by table-funding the loan; therefore, duty standards should apply to all originators.

E. Requirement that investors pay rating agencies instead of issuers.

The only way to ensure that rating agencies provide objective and accurate ratings is to change their financial relationship with the issuers of mortgage-backed securities. Securities issuers have an incentive to distort the truth about what's in these securities pools. Investors, on the other hand, have an incentive to get the best information possible about the makeup of the deals they put their money into. So it should be the investors—not the issuers—who pay the rating agencies for their assessments of mortgage-backed securities.

III. ADEQUATE OVERSIGHT

Regulators' glaring failure to provide adequate oversight within their existing regulatory structures was a key cause of this crisis. Adequate oversight is vital to a healthy market—both to protect consumers and to ensure safety and soundness of the financial system. As Sheila Bair recently stated, "Protecting the consumer from . . . perils is not simply a do-good public service. In fact, consumer protection, and safe and sound lending practices are two sides of the same coin."[147]

For consumer protections to be meaningful, they must be enforceable, as provided for by S 2452, Chairman Dodd's Homeownership Preservation and Protection Act of 2007.

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[1] Statement by Michael Fratantoni, senior economist with Mortgage Bankers Association, MBA as quoted by Kirstin Downey in *Dim Forecast for Risky Mortgages*, Washington Post, December 20, 2006.

[2] See CRL issue paper, *Subprime Lending: A Net Drain on Homeownership* (March 27, 2007), *available at* http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf.

[3] For a detailed discussion of judicial loan modifications, *see* our previous testimony, Testimony of Eric Stein, Center for Responsible Lending, Before the U.S. Senate Judiciary Committee, Dec. 5, 2007, *available at* http://www.responsiblelending.org/pdfs/stein-statement-to-senate-judiciary-looming-foreclosure-crisis.pdf.

[4] Under current proposals, loan modifications would be available only where the homeowner's income is insufficient, after deducting for modest IRS-approved living expenses, to cover the mortgage payments. In addition, there is a good faith requirement that allows courts to exclude anyone who wrongly makes it through existing hurdles.

[5] The same phenomenon occurred when Chapter 12 was passed to modify loans on family farms in the late 1980s.

[6] *Lewis Ranieri to deliver Dunlop Lecture on Oct. 1*, Harvard University Gazette, Sept. 25, 2008, *available at* http://www.news.harvard.edu/gazette/2008/09.25/06-dunlop.html.

[7] Lewis S. Ranieri, "Revolution in Mortgage Finance," the 9th annual John T. Dunlop Lecture at Harvard Graduate School of Design, Oct. 1, 2008, *available at* http://www.jchs.harvard.edu/events/dunlop_lecture_ranieri_2008.mov (last visited Oct. 13, 2008). Ranieri, is "chairman, CEO, and president of Ranieri & Co. Inc. and chairman of American Financial Realty Trust, Capital Lease Funding Inc., Computer Associates International Inc., Franklin Bank Corp., and Root Markets Inc. He has served on the National Association of Home Builders Mortgage Roundtable since 1989. . . ." *Harvard University Gazette*, Sept. 25, 2008.

[8] For a more detailed discussion of assignee liability, *see* our previous testimony, Testimony of Michael D. Calhoun, Center for Responsible Lending, Before the U.S. House Committee on Financial Services Subcommittee on Financial Institutions and Consumer Credit, May 8, 2007, *available at* http://www.responsiblelending.org/pdfs/Sec_Market_Testimy-Calhoun-FINAL-_2_.pdf. For another account

recommending lifting current restrictions on assignee liability, *see* Ren S. Essene and William Apgar, Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans, Joint Center for Housing Studies –Harvard University (April 25, 2007), *available at* http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf.

[9] Since 1976, under the Federal Trade Commission Act, there has been assignee liability for many home improvement and mobile home mortgages that are nevertheless regularly securitized. The federal Truth in Lending Act likewise provides for limited assignee liability outside of HOEPA as well as a right of rescission that applies to assignees. Car loans also widely carry assignee liability into the securitization market under many state retail installment sales laws. Even standard commercial law, enacted in virtually every state through the Uniform Commercial Code, provides for some degree of assignee liability. For further discussion, *see* Testimony of Michael D. Calhoun, May 8, 2007.

[10] *See* Center For American Progress, Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages, April 2008, *available at* http://www.americanprogress.org/issues/2008/04/reimc_brief.html.

[11] Median usual weekly earnings of employed full time wage and salary workers data from the Current Population Survey, retrieved from U.S. Bureau of Labor and Statistics website. Even at the 75th and 90th percentiles of wages, real wage gains have been limited to 4.8% and 8.7%, respectively. Housing price data from Standard and Poor's S&P / Case-Shiller Home Price Indices and CPI from the Bureau of Labor Statistics.

[12] Sharad Chaudhary, "An Introduction to the Subprime Mortgage Sector", Bank of America RMBS Trading Desk Strategy (June 27, 2007).

[13] Wei Li and Keith Ernst, "Do State Predatory Lending Laws Work?", Housing Policy Debate, Vol. 18, Issue 2 at page 361 (2007), *available at* http://www.mi.vt.edu/data/files/hpd%2018.2/6.hpd_wei-ernst_web.pdf.

[14] *Id.* Moreover, a huge portion of so-called "stated-income" loans were underwritten using dramatically inflated incomes when compared to IRS documents (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)) and lenders routinely failed to verify income even when they could have done so easily. *See*, *e.g.*, Gretchen Morgenson, *Inside the Countrywide Spending Spree*, New York Times, Aug. 26, 2008; Mike Hudson, Center for Responsible Lending, *IndyMac: What Went Wrong: How an "Alt-A" Leader Fueled Its Growth With Unsound and Abusive Mortgage Lending*, June 30, 2008, *available at* http://www.responsiblelending.org/pdfs/indymac_what_went_wrong.pdf (hereafter IndyMac Report).

[15] Most homeowners with prime mortgages maintain escrow accounts. *See, e.g.*, Fannie Mae "Single Family Selling Guide" Part VII, Section 104.05 ("First mortgages generally must provide for the deposit of escrow funds to pay as they come due taxes, ground rents, premiums for borrower-purchased mortgage insurance (if applicable), and premiums for hazard insurance and flood insurance...")

[16] *See* Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground*, Center for Responsible Lending (Dec. 2006), *available at* http://www.responsiblelending.org/pdfs/FC-paper-12-19-new-cover-1.pdf.

[17] Countrywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," Oct. 26, 2007.

[18] Credit Suisse, *Foreclosure trends—A sobering reality: 6.5 million borrowers expected to fall into foreclosure over the next five years*, April 23, 2008.

[19] MBA National Delinquency Survey, 2nd quarter 2008. The 5.5 million reported by survey, divided by 0.85 to scale up to market size (accounting for underreporting), multiplied by 0.047, the 2Q 2008 foreclosure start rate, multiplied by 4 to annualize. Another 1.2 million were delinquent but not in foreclosure, and another 492,000 were sitting in foreclosure from previous quarters' foreclosure starts.

[20] In May of 2007, MBA Chairman said: "As we can clearly see, this is not a macro-economic event. No seismic financial occurrence is about to overwhelm the U.S. economy." Statement of John M. Robbins, CMB, Chairman, Mortgage Bankers Association at the National Press Club's Newsmakers Lunch – Washington, DC (May 22, 2007), *available at* http://64.233.169.104/search?q=cache:DClB6ScFSu8J:www.mortgagebankers.org/files/News/InternalResource/54451_NewsRelease.doc+%22seismic+financial+occurrence%22+%26+John+M.+Robbins+%26+mortgage+bankers+association&hl=en&ct=clnk&cd=4&gl=us; *see also* Julia A. Seymour, "Subprime Reporting , Networks blame lenders, not borrowers for foreclosure 'epidemic,'" Business & Media Institute (Mar. 28, 2007) ("[T]here are experts who say the subprime 'meltdown' is not the catastrophe reporters and legislators are making it out to be. 'We don't believe it will spill over into the prime market or the U.S. economy,' said [Laura] Armstrong [Vice President, Public Affairs] of the Mortgage Bankers Association.").

[21] *See* Jody Shenn, *Libor Rise to Boost Subprime ARM Defaults 10%, Citigroup Says*, Bloomberg News, Oct.7, 2008.

[22] One in four Option ARMs made between 2004 and 2007 and still outstanding is delinquent. Sixteen percent are seriously delinquent (90 days + , REO, or in foreclosure). Upcoming payment shocks on these loans typically range from increases of 50% to 150% on required payments. Fitch Ratings, *Option ARMs: It's Later Than It Seems*, Structured Finance Residential Mortgage Special Report, Sept.2, 2008.

[23] James R. Hagerty and Ruth Simon, *Housing Pain Gauge: Nearly 1 in 6 Owners "Under Water,"* Wall Street Journal, Oct. 8, 2008, *available at* http://online.wsj.com/article/SB122341352084512611.html?mod=googlenews_wsj.

[24] Kristopher Gerardi, Adam Hale Shapiro, and Paul S. Willen, Federal Reserve Bank of Boston Working Papers, Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures, May 4, 2008, *available at* http://www.bos.frb.org/economic/wp/wp2007/wp0715.pdf.

[25] Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, (vol. 18, issue 2, 2007), *available at* http://www.mi.vt.edu/data/files/hpd%2018.2/5.hpd_quercia_web.pdf.

[26] These new projections, representing only property value declines caused by nearby foreclosures, not other price drops associated with the slowdown in local housing markets, are based on CRL research combined with data from Merrill Lynch, Moody's Economy.com, and the Mortgage Bankers Association. CRL Issue Brief, *Updated Projections of Subprime Foreclosures in the United States and Their Impact on Home Values and Communities*, Rev. Aug. 2008, *available at* http://www.responsiblelending.org/issues/mortgage/research/updated-projections-of-subprime-foreclosures-in-the-united-states-and-their-impact-on-home-values-and-communities.html.

[27] *See* HOPE NOW Data spanning July 2007 to July 2008, *available at* http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf (reporting higher prime and subprime loans seriously delinquent as of July 2008 than any previous month reported).

[28] HOPE NOW Data, July 2008, *available at* http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf (reporting 197,000 foreclosure starts and 192,000 repayment plans initiated and modifications completed, combined in July 2008).

[29] Analysis of Subprime Servicing Performance , State Foreclosure Prevention Working Group, Sept. 2008, *available at* http://www.mass.gov/Cago/docs/press/2008_09_29_foreclosure_report_attachment1.pdf.

[30] Inside Mortgage Finance Reprints, Subprime Debt Outstanding Falls, Servicers Pushed on Loan Mods (Nov. 16, 2007) (Quoting Karen Weaver, a managing director and global head of securitization research at Deutsche Bank Securities).

[31] Credit Suisse, *Mortgage Liquidity du Jour: Underestimated No More* (March 12, 2007) at 5.

[32] Credit Suisse, *Subprime Loan Modifications Update*, Oct. 1, 2008, at p. 8.

[33] See Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications*, Apr. 5, 2007 (noting specific examples of PSAs with various modification restrictions, including 5% by balance, 5% by loan count, limits on frequency, and limits on interest rate).

[34] *See, generally*, Gretchen Morgenson, *Silence of the Lender: Is Anyone Listening?*, New York Times, July 13, 2008.

[35] Homeownership Preservation Summit Statement of Principles (May 2, 2007), *available at* http://dodd.senate.gov/index.php?q=node/3870/print (The Principles were announced by Senator Dodd and endorsed by the Mortgage Bankers Association, CitiGroup, Chase, Litton, HSBC, Countrywide, Wells, AFSA, Option One, Freddie Mac, and Fannie Mae).

[36] State Foreclosures Working Group, Sept. 2008.

[37] Credit Suisse, *Subprime Loan Modifications Update*, Oct. 1, 2008.

[38] For more on aggressive marketing, *see* Ren S. Essene and William Apgar, *Understanding Mortgage Market Behavior: Creating Good Mortgage Options For All Americans*, Joint Center For Housing Studies At Harvard University (April 25, 2007), *available at* http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf.

[39] *Who's Holding the Bag?*, Presentation by Pershing Square Capital Management, L.P., p. 9 (May 2007), *available at* http://www.designs.valueinvestorinsight.com/bonus/pdf/IraSohnFinal.pdf (last visited Oct. 14, 2008).

[40] Jon Meacham and Daniel Gross, *The Oracle Reveals All: Did the Fed Cause the Real Estate Bubble to Burst? Are We Entering a Recession? And Who Should Be Our Next President? A Candid Conversation*, Newsweek (September 24, 2007).

[41] Brad Hintz, Michael Werner and Bryan St. John, "U.S. Securities Industry: The Sub-Prime Mortgage Blues," Bernstein Research, Feb. 16, 2007.

[42] At the time of its failure, for example, Bear Stearns leverage ratio exceeded 35 to 1. Roddy Boyd, *The Last Days of Bear Stearns*, Mar. 31, 2008, *available at* http://money.cnn.com/2008/03/28/magazines/fortune/boyd_bear.fortune/.

[43] Roger Lowenstein, "Triple-A Failure," New York Times Magazine, April 27, 2008.

[44] In one study, Lowenstein notes, a Drexel University researcher compared default rates (during the boom years before the mortgage bubble burst) on corporate bonds rated Baa and collateralized debt obligations with similar ratings. The CDOs—which were generally stocked with mortgage-related securities—defaulted at a rate eight times as often as their corporate cousins. Lowenstein: "One interpretation of the data is that Moody's was far less discerning when the client was a Wall Street securitizer."

[45] Lowenstein, "Triple-A Failure."

[46] *Id.*

[47] Gretchen Morgenson, *Inside the Countrywide Spending Spree*, New York Times (August 26, 2008).

[48] Vikas Bajaj and Christine Haughney, *Tremors at the Door: More People with Weak Credit Are Defaulting on Mortgages*, New York Times (January 26, 2007).

[49] One look at a broker's rate sheet makes it clear that brokers had every financial incentive to make riskier, more expensive loans. As recently as February 2008, Bear Stearns' rate sheet told its brokers that their maximum 1% yield-spread premium would be cut in half on loans without a prepayment penalty. Bear Stearns, Wholesale Subprime Discount Rate Sheet, Feb. 19, 2008, on file with CRL.

[50] Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, Wall Street Journal at A1 (Dec. 3, 2007).

[51] Letter from Coalition for Fair & Affordable Lending to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner (Jan. 25, 2007) at 3.

[52] *See, e.g.*, Glenn R. Simpson and James R. Hagerty, *Countrywide Loss Focuses Attention on Underwriting*, Wall Street Journal (Apr. 30, 2008).

[53] *Steered Wrong, supra* note 2. *Id.* That extra money, of course, is paid by the consumers in those subprime loans who could have—*should* have—been in the lower cost prime loans, and, but for the perverse incentives making those loans better for the middlemen, might have been.

[54] *See* Testimony of Harry H. Dinham, President, National Association of Mortgage Brokers, before the U.S. House of Representatives Committee on Financial Services' Subcommittee on Financial Institutions and Consumer Credit, March 27, 2008, at 8.

[55] *See, e.g*., Gretchen Morgenson, *Illinois to Sue Countrywide*, N.Y. Times, June 25, 2008 (noting that the Illinois Attorney General's complaint alleges that the "vast majority" of loans made by one Illinois mortgage broker had inflated income, "almost all without the borrower's knowledge.").

[56] Ruth Simon and James R. Hagerty, *Countrywide's New Scare— Option ARM' Delinquencies Bleed Into Profitable Prime Mortgages*, Wall Street Journal, Oct. 24, 2007.

[57] *See* Gretchen Morgenson and Geraldine Fabrikant, *Countrywide's Chief Salesman and Defender*, N.Y. Times, Nov. 11, 2007 (noting former employee who said commission structure rewarded sales representatives for making risky, high-cost loans, including, for example, a commission increase of 1% of loan value for attaching a three-year prepayment penalty; noting that the higher the interest at reset, the higher the broker's commission).

[58] Mike Hudson, Center for Responsible Lending, *IndyMac: What Went Wrong: How an "Alt-A" Leader Fueled Its Growth With Unsound and Abusive Mortgage Lending*, June 30, 2008, *available at* http://www.responsiblelending.org/pdfs/indymac_what_went_wrong.pdf (hereafter IndyMac Report).

[59] IndyMac Report at 2 (IndyMac approved a brokered loan claiming an 80-year-old living solely on SSI earned nearly $4,000 per month; IndyMac instructed a mortgage broker to send SSI letters with the dollar amount expunged: "Need copy of SSI letter blacked out for the last 2 yrs w/no ref to income" (citing Manuel v. American Residential Financing, Inc., et al, Superior Court of Gwinnett County, State of Georgia, April 3, 2008)).

[60] IndyMac Report at 3 (citing IndyMac Bancorp Inc., 8K filing with Securities and Exchange Commission, May 12, 2008. Before its demise, IndyMac had moved decidedly back in the direction of fully documenting borrowers income and other particulars, with 69% of its loan volume in March 2008 involving "full-doc" mortgages).

[61] In *re: New Century TRS Holdings, Inc., a Delaware corporation, et al*., Final Report of Michael J. Missal, Bankruptcy Court Examiner, Chapter 11, Case No. 07-10416 (KJC), Feb. 29, 2008, *available at* http://www.klgates.com/FCWSite/Final_Report_New_Century.pdf at 130.

[62] Debra Cassens Weiss, *New Century GC Sounded Early Warning About Subprime Exposure*, ABA Journal, March 31, 2008.

[63] For example, prepayment penalties in the subprime market have been demonstrated to increase foreclosure rates 16 to 20 percent. Quercia. Stegman, & Davis, *supra*. However, the Board did nothing to rein them in until July of this year.

[64] Representative Leach, Hearing on Predatory Lending Practices, U.S. House Committee on Banking and Financial Services, May 24, 2000, *available at* http://commdocs.house.gov/committees/bank/hba64810.000/hba64810_0.htm (last visited Oct. 10, 2008).

[65] Testimony of Martin Eakes, CEO, Center for Community Self-Help, Before the House Committee on Banking and Financial Services, May 24, 2000, *available at* http://financialservices.house.gov/banking/52400eak.htm#N_14_.

[66] *See* Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending (Feb. 23, 2006), *available at* http://www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf.

[67] *See* Stephen Labaton, *Agency's '04 Rule Let Banks Pile on Debt*, N.Y. Times, Oct. 2, 2008.

[68] Press Release, Securities and Exchange Commission, , Chairman Cox Announces End of Consolidated Supervised Entities Program (publishing Written Statement of Christopher Cox), Sept. 26, 2008.

[69] Labaton, *Agency's '04 Rule Let Banks Pile on Debt*, N.Y. Times, Oct. 2, 2008 (citing an inspector general's report issued Sept. 26, 2008).

[70] Steve Dunbar, *Unregulated Swaps Hastened Wall Street Collapse*, Associated Press, Oct. 7, 2008 (quoting Michael Greenberger, former director of trading and markets for the Commodity Futures Trading Commission: "Were it not for that insurance, it certainly wouldn't have reached this manic state of growth," Greenberger said of the questionable investments.).

[71] *Id.* (citing estimates of notional value from the International Swaps and Derivatives Association as of the end of 2007 and noting that the figure is "roughly five times the entire U.S. production of goods and services last year.").

[72] Former Comptroller John D. Hawke, Jr. described the OCC's use of its power to override state laws protecting consumers as "one of the advantages of a national charter," and asserted that he was "not the least bit ashamed to promote it." The fact that the OCC is funded by assessments from the banks it regulates, rather than by Congressional appropriations (in 2005, 97% of the OCC's operations were funded by revenues from assessments), feeds a race to the bottom to attract institutions to its charter. *See* OCC, Annual Report, Fiscal Year 2005 at 7, *available at* www.occ.treas.gov/annrpt/2005AnnualReport.pdf; Jess Bravin & Paul Beckett, "Friendly Watchdog: Federal Regulator Often Helps Banks Fighting Consumers– Dependent on Lenders' Fees, the OCC Takes Banks' Side Against Local, State Laws," at A1 *Wall St. Journal* (Jan. 28, 2002).

[73] *See* 68 Fed. Reg. 46264 (Aug. 5, 2003); 68 Fed. Reg. 46119 (Aug. 5, 2003). *See also* 68 Fed. Reg. at 1911-12 nn.57, 59 (invoking the Georgia law as an example of the application of its preemption standard); *see also* Nicholas Bagley, *The Unwarranted Regulatory Preemption of Predatory Lending Laws*, 79 N.Y.U.L. Rev. 2274, 2295 (2004). For thoughtful academic criticisms of the OCC's preemption of state anti-predatory lending laws and other consumer protection laws, *see generally* Azmy, 57 Fla. L. Rev. at 295 (discussing the Georgia Fair Lending Act preemption at pages 385-88); Christopher L. Peterson, 78 Temple L. Rev. at 1, *supra*; Bagley, *Id.*; Vincent DiLorenzo, "Federalism, Consumer Protection and Preemption: A Case for Heightened Judicial Review," *St. John's Legal Studies Research Paper #09-0026* (Sept. 2005), *available at* http://ssrn.com/abstract=796147; Arthur E. Wilmarth, Jr., "The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection," 23 *Ann. Rev. of Banking & Fin. Law*, 225, 232 (2004).

[74] Robert Berner & Brian Grow, "They warned us about the Mortgage Crisis," *Business Week* (Oct. 9, 2008), *available at:* http://www.businessweek.com/magazine/content/08_42/b4104036827981.htm.

[75] *Id.*

[76] *Id.* (quoting North Carolina Attorney General Roy Cooper).

[77] *Id.*

[78] *See, e.g.*, OCC News Release 2003-8: OCC Issues Guidelines to National Banks to Guard Against Abusive Lending Practices (Feb. 21, 2003) (comments by Comptroller Hawke that "while the OCC has *no reason to believe that any national bank is engaging in predatory lending*, the agency's guidance will help prevent problems from arising in the future by prescribing steps national banks should take to avoid abusive practices."); Statement Of Comptroller Of The Currency John D. Hawke, Jr. Regarding The Issuance Of Regulations Concerning Preemption And Visitorial Powers (Jan. 7, 2004) ("We have no evidence that national banks (or their subsidiaries) are engaged in such practices to any discernible degree."); OCC, News Release 2004-3: OCC Issues Final Rules on National Bank Preemption and Visitorial Powers; Includes Strong Standard to Keep Predatory Lending out of National Banks (Jan. 7, 2004) ("There is scant evidence that regulated banks are engaged in abusive or predatory practices").

[79] Robert Berner & Brian Grow, "They warned us about the Mortgage Crisis," *Business Week* (October 9, 2008). The OCC's response to consumer complaints has been equally unimpressive. Although the OCC is required to have a separate consumer affairs division, 15 U.S.C. § 57a(f)(1), and largely relies on direct consumer contact with the bank as "the most effective way to resolve a complaint …" *See* OCC, Annual Report Fiscal Year 2004, at 19 (Oct. 2004), *available at* http://www.occ.treas.gov/annrpt/2004AnnualReport.pdf; OCC, 2004 Report of the Ombudsman, at 38 (Dec. 2004), *available at* http://www.occ.treas.gov/2004Report.pdf.

[80] This bank failed and was taken over by the FDIC on March 12, 2004. *See* http://www.fdic.gov/bank/individual/failed/gnb.html.

[81] Center for Responsible Lending, "Comments on OCC Working Paper" at 8-10 (Oct. 6, 2003), *available at* http://www.responsiblelending.org/pdfs/CRLCommentsonOCCWorkingPaper.pdf. The practices included charging exorbitant broker fees, imposing unfair prepayment penalties, evading HOEPA and other consumer protection laws, the high prevalence of 2/28 ARM loans accompanied by 3-year prepayment penalty provisions, as well as racial steering and lending discrimination. *Id.*

[82] Yalman Onaran, "Banks' Subprime Losses Top $500 Billion on Writedowns (Update 1)" (Aug. 12, 2008), *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=a8sW0n1Cs1tY&refer=home#.

[83] *Id.*

[84] Countrywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," October 26, 2007.

[85] Lehman Brothers, "Residential Credit: Estimating Option ARM Losses" at 4 *MBS Strategy Weekly* (June 20, 2008).

[86] Office of Inspector General, Department of the Treasury, "Material Loss Review of NetBank, FSB," April 23, 2008; OIG-08-032, p. 1.

[87] *Id.* at 3.

[88] The bank had roughly $307 billion in assets and $188 billion of deposits. WaMu was nearly 700% bigger than the largest previous U.S. bank to fail, Continental Illinois National Bank & Trust, which had $40 billion in assets when it went under in 1984.

[89] *Ferguson v. IndyMac Bank*, U.S. District Court for the Eastern District of New York, filed Feb. 14, 2008, *available at* http://www.responsiblelending.org/pdfs/indy-ferguson-brooklyn.pdf.

[90] IndyMac's dollar volume of non-performing assets exploded 11-fold in 15 months—going from $184 million (0.63% of assets) at the close of 2006 to $2.1 billion (6.51% of assets) at the end of the first quarter of 2008. Highline Financial—a research service that rates the safety of banks and thrifts on a 99 (best) to zero (worst) scale—dropped its rating on IndyMac from 55 at the end of 2006 to 1 at the end of 2007—and then down to zero in March 2008. Kathleen Pender, *Why wasn't IndyMac on FDIC problem list?*, San Francisco Chronicle, July 24, 2008.

[91] Karey Wutkowski, "FDIC says IndyMac failure costlier than expected," Reuters, August 26, 2008.

[92] Mark Gimein, "Inside the Liar's Loan," *Slate*, April 24, 2008; "Bring on the Alt-A Downgrades," *Mish's Global Economic Trend Analysis*, May 29, 2008.

[93] Pierre Thomas and Lauren Pearle, "Exclusive: WaMu Insiders Claim Execs Ignored Warnings, Encouraged Reckless lending," ABCNews.com, Oct. 13, 2008.

[94] *The People of the State of New York v. First American et al*, filed Nov. 1, 2007, New York County Supreme Court. WaMu was not named as a defendant in the case because of the federal preemption policy pushed by OTS and other federal regulators, which in many instances exempts federally licensed banks from action by state courts or state authorities.

[95] "NY Attorney General Sues First American And Its Subsidiary For Conspiring with Washington Mutual To Inflate Real Estate Values," Media Release, New York State Attorney General's Office, Nov. 1, 2007. In a private lawsuit filed two months later, a California appraiser claimed WaMu had blacklisted her because she refused to falsify appraisal documents. She alleged that WaMu officials took her off their preferred appraiser list in 2007 because she accurately reported that home values were falling in areas where she was doing appraisals. See Amir Efrati, "WaMu accused of Blacklisting Appraiser Over Home Prices," Dow Jones News Service, Jan. 17, 2008.

[96] Press Release, Freddie Mac, *Freddie Mac Announces Tougher Subprime Lending Standards to Help Reduce the Risk of Future Borrower Default*, Feb. 27, 2007, *available at* http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/02-27-2007/0004535243&EDATE.

[97] Statement of OFHEO Director James B. Lockhart on Issuance of Letters by Fannie Mae and Freddie Mac Regarding Nontraditional and Subprime Mortgage Products, July 17, 2007, *available at* http://www.ofheo.gov/NewsRoom.aspx?Q1=0&Q2=0&FormMode=Detail&ID=370.

[98] Testimony of Martin Eakes, CEO, Center for Responsible Lending and Center for Community Self-Help, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Feb. 7, 2007, at 20, *available at* http://www.responsiblelending.org/pdfs/martin-testimony.pdf.

[99] *See, e.g.*, July 16, 2004 comment letter to HUD from Stephen Brobeck, Executive Director, Consumer Federation of America; Ira Rheingold, Executive Director National Association of Consumer Advocates; John Taylor, President and CEO, National Community Reinvestment Coalition; Roy O. Priest, President and CEO, National Congress for Community Economic Development; Sheila Crowley, President, National Low Income Housing Coalition; and June 30, 2004 comment letter to HUD from F. Barton Harvey III, Chairman of the Board and Chief Executive Officer, The Enterprise Foundation and Michael Rubinger, President, Local Initiatives Support Corporation.

[100] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, Housing Policy Debate, (15)(3): (2004); Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms* (2006) *available at* http://www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf.

[101] For further discussions of how CRA has aided rather than harmed communities, *see* Janet L. Yellen, Opening Remarks to the 2008 National Interagency Community Reinvestment Conference, San Francisco, California (March 31, 2008) (noting that studies have shown that the CRA has increased the volume of responsible lending to low- and moderate-income households); Ann F. Jaedicke, Testimony Before the Committee on Financial Services, US House of Representatives (February 13, 2008) (nothing "over half of subprime mortgages of the last several years—and the

ones with the most questionable underwriting standards—were originated through mortgage brokers for securitization by nonbanks, including major investment banks"); Michael S. Barr, "Credit Where It Counts: Maintaining a Strong Community Reinvestment Act," Brookings Institution Research Brief (May 2005) (stating "encouraged by the law, banks and thrifts have developed expertise in serving low-income communities.").

[102] According to Michael Barr, 80 percent of subprime loans were made by players not covered under CRA: "More than half of subprime loans were made by independent mortgage companies not subject to comprehensive federal supervision; another 30 percent of such originations were made by affiliates of banks or thrifts, which are not subject to routine examination or supervision, and the remaining 20 percent were made by banks and thrifts [covered by CRA]." Testimony of Michael Barr, Before the House Committee on Financial Services, Feb. 13, 2008, *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/barr021308.pdf.

[103] Inside Mortgage Finance, 2008 Mortgage Market Statistical Annual, Volume 1 (2008). They accounted for $226 billion in loans out of a total subprime industry volume of approximately $1.2 trillion. Ameriquest was perhaps the most predatory of all lenders, paying a $325 million multi-state fraud settlement, and New Century is being investigated for accounting fraud and other alleged bad practices.

[104] Traiger & Hinckley LLP, The Community Reinvestment Act: A Welcome Anomaly in the Foreclosure Crisis Indications that the CRA Deterred Irresponsible Lending in the 15 Most Populous U.S. Metropolitan Areas, Jan. 8, 2008, available at http://www.traigerlaw.com/publications/traiger_hinckley_llp_cra_foreclosure_study_1-7-08.pdf, http://www.traigerlaw.com/publications/addendum_to_traiger_hinckley_llp_cra_foreclosure_study_1-14-08.pdf.

[105] *Id.*

[106] Daniel Gross, *Subprime Suspects: The Right Blames the Credit Crisis on Poor Minority Homeowners. This Is Not Merely Offensive, But Entirely Wrong*, Newsweek, *available at* http://www.newsweek.com/id/162789 .

[107] *Id.*

[108] Introduction to July 2008 Federal Reserve Final HOEPA rule, 12 CFR Part 226 Truth in Lending; Final Rule, 73 Fed. Reg. 44522, 44526.

[109] Wall Street Journal, *Subprime Debacle Traps Even Very Credit-Worthy as Housing Boomed, Industry Pushed Loans to a Broader Market* (December 3, 2007).

[110] CRL Research, *Net Drain.*

[111] *Id.*

[112] Based on data collected under the Home Mortgage Disclosure Act for loans made in 2006, the average subprime loan amount for owner-occupied, first lien, single-family homes was $205,700. The median price was $159,000.

[113] American Banker, Wachovia Alum Has Tips for an Industry Rebound (September 15, 2008).

[114] *See* Fannie Mae Single Family Selling Guide, *available at* http://www.allregs.com/efnma/index.asp?dv=0&id=a&ii=0&im=0&io=fnma&ip=/&iq=0&iv=0&iw=0&iy=0&iz=0&fc=0&fk=_&fm=0&fs=0&fv=0&sd=/&sm=1&sp=fnma&sq=_&st=_&sv=0&sx=/&sy=0&sz=0&t=0&tc=fnma&tp=/&td=0&ti=0&tm=0&to=fnma&tw=0&tv=0&tq=0&tx=/; Freddie Mac Seller/Servicer Guide, *available at* http://www.freddiemac.com/sell/guide/#.

[115] Testimony of Martin Eakes Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, "Preserving the American Dream: Predatory Lending Practices and Home Foreclosures," (Feb. 7, 2007), *available at* http://www.responsiblelending.org/pdfs/martin-testimony.pdf, at 3, 17-18.

[116] Center for Responsible Lending, "Freddie Mac Bans Unaffordable Subprime Home Loans," (Feb. 27, 2007), *available at* http://www.responsiblelending.org/press/releases/page.jsp?itemID=31767669.

[117] Major D. Coleman IV, Michael LaCour-Little, Kerry D. Vandell, *Subprime Lending and the Housing Bubble: Tail Wags Dog?*, Working Paper, Sept. 2, 2008, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1262365.

[118] *See* David Goldstein and Kevin G. Hall, "Private sector loans, not Fannie or Freddie, triggered crisis," McClatchy Newspapers (Oct. 11, 2008), *available at* http://www.mcclatchydc.com/251/story/53802.html ("Between 2004 and 2006, when subprime lending was exploding, Fannie and Freddie went from holding a high of 48% of the subprime loans that were sold into the secondary market to holding about 24%, according to data from Inside Mortgage Finance, a specialty publication. One reason is that Fannie and Freddie were subject to tougher standards than many of the unregulated players in the private sector who weakened lending standards, most of whom have gone bankrupt or are now in deep trouble. During those same explosive three years, private investment banks—not Fannie and Freddie—dominated the mortgage loans that were packaged and sold into the secondary mortgage market. In 2005 and 2006, the private sector securitized almost two thirds of all U.S. mortgages, supplanting Fannie and Freddie, according to a number of specialty publications that track this data.")

[119] *Inside the GSEs*, Jan. 3, 2007, p. 4. These securities are divided into tranches, with the AAA tranches being the least risky, and for this reason the easiest to sell to investors; because there was broad investor demand for them, their marketability didn't depend on the GSEs. The harder securities to sell are those from the subordinate tranches. These were made palatable to investors through the creation of collateralized debt obligations, which repackaged BBB tranches into, in part, a new set of AAA tranches, which help to further market the securities; to my knowledge the GSEs did not invest in CDOs. It was the ability to fund the riskiest portion of subprime mortgage loans that made possible the explosive growth of subprime lending. See Pershing Square Capital Management, L.P., Who's Holding the Bag, Presentation, May 2007, *available at* http://www.designs.valueinvestorinsight.com/bonus/pdf/IraSohnFinal.pdf.

[120] Federal Home Loan Mortgage Corporation, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.28, *available at* http://www.freddiemac.com/investors/; Federal National Mortgage Association, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.45, *available at* http://www.fanniemae.com/ir/pdf/earnings/2008/q22008.pdf.

[121] This is a one-time impairment charge, all of which Freddie Mac does not expect to ultimately lose; this is in contrast to on-going, recognized losses on Alt-A loans that are 50% or more of the total credit losses experienced year-to-date. See Federal Home Loan Mortgage Corporation, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.37 & 71, *available at* http://www.freddiemac.com/investors/.

[122] Fannie Mae, Investor presentation, "Fannie Mae 2008 Q2 10-Q Investor Summary," (Aug. 6, 2008), p.30, *available at* http://www.fanniemae.com/media/pdf/newsreleases/2008_Q2_10Q_Investor_Summary.pdf.

[123] Charles Duhigg, Pressured to Take More Risk, Fannie Reached Tipping Point, N.Y. Times, Oct. 4, 2008.

[124] *Id.*

[125] Fannie Mae, Investor presentation, "Fannie Mae 2008 Q2 10-Q Investor Summary," (Aug. 6, 2008), p.36, *available at* http://www.fanniemae.com/media/pdf/newsreleases/2008_Q2_10Q_Investor_Summary.pdf.

[126] Federal National Mortgage Association, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.6, *available at* http://www.fanniemae.com/ir/pdf/earnings/2008/q22008.pdf; Federal Home Loan Mortgage Corporation, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.71, *available at* http://www.freddiemac.com/investors/.

[127] Freddie Mac, "Freddie Mac's Second Quarter 2008 Financial Results," Investor presentation, (Aug. 6,2008), p.4, *available at* http://www.freddiemac.com/investors/er/pdf/slides_080608.pdf.

[128] Tom Deutsch, Deputy Executive Director, American Securitization Forum, Milken Institute, "Financial Innovations Lab on Housing: Beyond the Crisis" (Oct. 7, 2008) at 11.

[129] *Available at* http://www.fanniemae.com/media/pdf/newsreleases/2008_Q2_10Q_Investor_Summary.pdf, at 37 (citing First American CoreLogic and LoanPerformance data).

[130] Median usual weekly earnings of employed full time wage and salary workers data from the Current Population Survey, retrieved from U.S. Bureau of Labor and Statistics website. Even at the 75th and 90th percentiles of wages, real wage gains have been limited to 4.8% and 8.7%, respectively. Housing price data from Standard and Poor's S&P / Case-Shiller Home Price Indices and CPI from the Bureau of Labor Statistics.

[131] Inside Mortgage Finance Publications, "The 2008 Mortgage Market Statistical Annual" (2008).

[132] Sharad Chaudhary, "An Introduction to the Subprime Mortgage Sector", Bank of America RMBS Trading Desk Strategy (June 27, 2007).

[133] CRL previous testimony has included these points.

[134] Countrywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," October 26, 2007.

[135] Wei Li and Keith Ernst, "Do State Predatory Lending Laws Work?", Housing Policy Debate, Vol. 18, Issue 2 at page 361 (2007) (available at http://www.mi.vt.edu/data/files/hpd%2018.2/6.hpd_wei-ernst_web.pdf).

[136] Moreover, a huge portion of so-called "stated-income" loans were underwritten using dramatically inflated incomes when compared to IRS documents (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)) and lenders routinely failed to verify income even when they could have done so easily. *See, e.g*., Gretchen Morgenson, *Inside the Countrywide Spending Spree*, New York Times (August 26, 2008); Mike Hudson, Center for Responsible Lending, *IndyMac: What Went Wrong: How an "Alt-A" Leader Fueled Its Growth With Unsound and Abusive Mortgage Lending*, June 30, 2008, *available at* http://www.responsiblelending.org/pdfs/indymac_what_went_wrong.pdf (hereafter IndyMac Report).

[137] *See* Li and Ernst; Fitch Ratings, "Drivers of 2006-2007 Alt-A Collateral Performance" (May 7, 2008).

[138] Most homeowners with prime mortgages maintain escrow accounts. *See, e.g.*, Fannie Mae "Single Family Selling Guide" Part VII, Section 104.05 ("First mortgages generally must provide for the deposit of escrow funds to pay as they come due taxes, ground rents, premiums for borrower-purchased mortgage insurance (if applicable), and premiums for hazard insurance and flood insurance...")

[139] *See* Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground*, Center for Responsible Lending (Dec. 2006) at 27, *available at* http://www.responsiblelending.org/pdfs/FC-paper-12-19-new-cover-1.pdf.

[140] *See, e.g,*. States' settlement agreement with Ameriquest, IV-B-5, http://www.state.ia.us/government/ag/images/pdfs/Ameriquest_SETTLMNT_FINAL.pdf; State of Iowa v. Household International, *Consent Judgment* Para. 9(E)(1), *available at* http://www.state.ia.us/government/ag/latest_news/releases/dec_2002/hhconsent.pdf; Federal Trade Commission vs. Citigroup, et al. Civ. No 1:01-CV-00606 (E.D. Ga., filed), Complaint, Para. 18-19, http://www.ftc.gov/os/2001/03/citigroupcmp.pdf.

[141] *Cf.* Federal Trade Commission "Facts for Consumers" *available at* http://www.ftc.gov/bcp/conline/pubs/homes/mortgserv.shtm ("It's important to maintain the required property

insurance on your home. If you don't, your servicer can buy insurance on your behalf. This type of policy is known as force placed insurance; it usually is more expensive than typical insurance; and it provides less coverage.")

[142] David C. Wheelock, *The Federal Response to Home Mortgage Distress: Lessons from the Great Depression*, Federal Reserve Bank of St. Louis *Review*, May/June, Part 1, 2008.

[143] Pollock, p. 2. HOLC purchased and restructured more than a million mortgages, 20% of all mortgages in the country, and over the life of the program, extended $3.5 billion in loans (the corresponding figures in today's economy would be 2.5 million loans worth $750 billion). It closed its books in 1951 having turned a small profit. Alan S. Blinder, "From the New Deal, a Way out of a Mess," The New York Times (Feb. 24, 2008).

[144] Remarks by Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on The Future of Mortgage Finance at the 2008 Annual Meeting National Association for Business Economics; Washington, D.C., Oct. 6, 2008, *available at* http://www.fdic.gov/news/news/speeches/chairman/spoct0608.html (last visited Oct. 12, 2008).

[145] For a more detailed discussion of assignee liability, *see* our previous testimony, Michael D. Calhoun, Center for Responsible Lending, U.S. House Committee on Financial Services Subcommittee on Financial Institutions and Consumer Credit, May 8, 2007, *available at* http://www.responsiblelending.org/pdfs/Sec_Market_Testimy-Calhoun-FINAL-_2_.pdf. For another account recommending lifting current restrictions on assignee liability, *see* Ren S. Essene and William Apgar, Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans, Joint Center for Housing Studies – Harvard University (April 25, 2007), *available at* http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf.

[146] Since 1976, under the Federal Trade Commission Act, there has been assignee liability for many home improvement and mobile home mortgages that are nevertheless regularly securitized. The federal Truth in Lending Act likewise provides for limited assignee liability outside of HOEPA as well as a right of rescission that applies to assignees. Car loans also widely carry assignee liability into the securitization market under many state retail installment sales laws. Even standard commercial law, enacted in virtually every state through the Uniform Commercial Code, provides for some degree of assignee liability. For further discussion, *see* Testimony of Michael D. Calhoun, Center for Responsible Lending, U.S. House Committee on Financial Services Subcommittee on Financial Institutions and Consumer Credit, May 8, 2007, *available at* http://www.responsiblelending.org/pdfs/Sec_Market_Testimy-Calhoun-FINAL-_2_.pdf.

[147] Remarks by Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on The Future of Mortgage Finance at the 2008 Annual Meeting National Association for Business Economics; Washington, D.C., Oct. 6, 2008, *available at* http://www.fdic.gov/news/news/speeches/chairman/spoct0608.html (last visited Oct. 12, 2008).