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Subcommittee on Financial Institutions and Consumer Credit

"The Role of the Secondary Market in Subprime Mortgage Lending"
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Chair Maloney, Ranking Member Gillmor, and members of the Committee, thank you for holding this hearing to focus on the secondary market's role in subprime mortgage lending. The secondary market has had, and will continue to have, an enormous impact on the quality of home loans received by families in this country, and I commend you for focusing on this vital issue.

My remarks today will emphasize these five points:

- There is an urgent need to address the epidemic of foreclosures in the subprime market today—the highest rate of home losses in the modern mortgage era.
- Wall Street has been a key driver in supporting these devastating losses.
- In fact, even now, lenders and mortgage investors continue to have strong incentives to encourage—and they continue to offer—dangerous loans that go directly against the best interests of home buyers.
- A typical mortgage loan passes through a number of hands, moving from broker to lender to loan servicers and investors. Accountability for loan quality must follow the loan wherever it goes.
- The most powerful entities in the mortgage industry—investors, rating agencies and the government-sponsored enterprises (GSEs)—have an obligation to take an active role in preventing even more losses on existing high-risk subprime loans. Wall Street must not stand in the way of modifying mortgages or other options to assist struggling homeowners.

I serve as the President of the Center for Responsible Lending (CRL) (www.responsiblelending.org). CRL is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL began as a coalition of groups in North Carolina that shared a concern about the rise of predatory lending in the late 1990s.

CRL is an affiliate of Self Help (www.self-help.org), which consists of a credit union and a non-profit loan fund. For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans. Self-Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country. Our loan losses have been less than one percent a year.

Before I took my current position with CRL, I oversaw Self-Help's secondary marketing operations, where we purchased low-income and minority home loans, often made to borrowers with blemished credit. We bought these loans from banks, held on to the credit risk, and resold the mortgages to Fannie Mae. We have used the secondary market to provide $4.5 billion of financing to 50,000 families across the country, loans that have performed well and significantly increased these families' wealth. Through this direct experience, I understand the importance of the secondary market in providing capital for future lending. In fact, the mortgage market as we know it today would not be possible without the vital support of the secondary market.

Historically, mortgages have been safe investments with a commensurate rate of return for investors. But the growth of the subprime market offered mortgages that provided a higher-risk investment with potential for higher returns. Wall Street became ravenous for these loans, seeking mortgages that provide a high yield. This demand from Wall Street encouraged subprime lenders to abandon reasonable qualifying standards, to forget about standard documentation requirements, and to ignore whether borrowers could actually afford the loan.

Responding to Wall Street's demand, lenders created dangerous loan products that appeared deceptively affordable to borrowers, and brokers pushed these products to earn high fees. In turn, rating agencies chose to tolerate the increasingly high volume of poorly underwritten, extremely dangerous loans included in mortgage investments—loans that any experienced underwriter would have seen were heading for foreclosure. The result is the rash of losses occurring today, as subprime lenders shut down, investors lose money, and worst of all, hard-working families lose their homes, their credit standing, and their financial security. Ultimately, the harm is extended to entire neighborhoods where foreclosures are concentrated, stripping wealth from communities and lowering the quality of life for all residents.

It didn't have to be this way. Mortgage underwriters are well aware of what kinds of loans are most likely to fail. Lenders have long experience with determining whether a borrower has the ability to repay a loan. It is well established that loans with certain traits—for example, subprime loans with adjustable interest rates, loans with built-in payment shock, subprime loans with prepayment penalties, loans that do not escrow for taxes and insurance, loans where borrower income is not documented—have a much higher risk of foreclosure. Yet, subprime lenders have been piling all of these characteristics into mortgages for people who are already financially stretched with a high debt burden. And Wall Street has colluded by taking these loans and calling them quality investments.

For Wall Street bankers, mortgage loans represent paper they trade—a financial instrument backed by mortgages that can be highly profitable. The performance of individual loans is of little concern as long as the loan pool as a whole provides the expected return. Because loans are sold on the secondary market, the parties who actually interact with the borrowers during the loan process—mortgage brokers and lenders—have very little financial interest in whether the loan performs beyond an early payment default period. But for the average American, a loan is much more than a piece of paper. Each individual loan represents the roof over their head and the bulk of their savings for the future. Families that get mortgages are seeking long-term security, but Wall Street has been seeking fast profits.

I. The Current Situation: An Epidemic of Foreclosures

Last December, the Center for Responsible Lending published a report that represents the first comprehensive, nationwide research projecting foreclosures in the subprime market. The report, "Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners," is based on an analysis of over six million subprime mortgages, and the findings are disturbing. Our results show that despite low interest rates and high housing appreciation during the past several years, the subprime market has experienced high foreclosure rates comparable to the worst foreclosure experience ever in the modern prime market. We also show that foreclosure rates will increase significantly in many markets as housing appreciation slows or reverses. As a result, **we project that 2.2 million borrowers will lose or have lost their homes and up to $164 billion of wealth** in the process. That translates into foreclosures on one in five subprime loans (19.4 percent) originated in recent years.[1]

Since we issued that report, the condition of the subprime market has deteriorated rapidly, and subsequent events have shown our projection to be conservative. A recent study by the investment bank, Lehman Brothers, shows that the number of 2006-originated loans likely to face foreclosure is 30 percent.[2]

Why does a foreclosure epidemic in the subprime mortgage market matter? First, subprime mortgages are no longer a niche market; they have become a significant share of all new mortgages made in America, making up well over 20 percent of all home loans originated recently and currently representing $1.2 trillion of mortgages currently outstanding.[3] Second, homeownership is the best and most accessible way most families have to acquire wealth and economic security. If home loans are actually setting citizens back rather than helping them build for the future, there are serious ramifications for local economies and the nation as a whole. The problem is particularly serious for communities of color, since more than half of African-American and 40 percent of Latino families who get home loans receive them in the subprime market.[4] If current trends continue, it is quite possible that subprime mortgages could cause the largest loss of African-American wealth in American history.

There are several factors driving massive home losses, including dangerous products, loose underwriting, broker abuses and federal neglect. In these remarks, I will focus on one other important factor: support by investors. In the simplest terms, the secondary market has enabled the subprime crisis. Much of the growth in subprime lending has been spurred by investors' appetite for high-risk mortgages that provide a high yield. While investors eventually do react and become more conservative when losses mount, the problem is that the market reaction occurs only after foreclosures are already rampant and hundreds of thousands, if not millions, of families have lost their homes, or have been placed into unsustainable loans that will lead to the same result.

II. Wall Street's Role in Subprime Foreclosures

The mortgage business has changed drastically since the days when families went to their local savings and loan to get a mortgage, and the thrift held that loan among its own investments. Today, most lenders sell their loans into the secondary market, where mortgages are pooled together and then divided into segments, or "tranches," which are then sold as securities to large numbers of investors. The investor has the right to collect payments and enforce the loan terms, including foreclosing on the home if the borrower defaults. As of June 30, 2006, mortgage-backed securities were the largest segment of the United States bond market, accounting for 23 percent of all bond market debt outstanding.[5]

Thus, a mortgage typically goes through a chain of players, some of whom take their cut of compensation immediately and pass the loan along to the next stage. The first link in the lending chain is typically a mortgage broker. Brokers, who originate 71 percent of subprime mortgages,[6] have a strong incentive to close as many loans as possible, but very little reason to consider the loans' future performance.[7] Brokers act as independent contractors for lenders, who in turn obtain capital and shield themselves from the full potential cost of foreclosures by selling their loans to investors. Together, third-party originations and the risk dispersion made possible through the secondary market help distance loan originators from seriously adverse consequences of foreclosures that occur after an early payment default period, which increases the prevalence of loans that fail.

Like lenders, mortgage investors use sophisticated financial tools to limit their financial exposure to losses from foreclosures. First, pools of loans in mortgage-backed securities typically contain both high-risk and lower-risk loans, and the income on the better-performing loans subsidizes the losses on defaulted loans. Second, mortgage-backed securities are often over-collateralized; that is, the amount of the loans backing the investment is greater than its face value. Third, investors may demand a premium from the lender/seller for investing in its subprime securities. Fourth, investors are protected by a legal doctrine called "holder in due course," which prevents borrowers from making claims against the purchaser of their loan, even if, for example, that loan contained abusive features.

Further, the only "regulatory" oversight of the secondary market comes from the third-party rating agencies, who evaluate the credit risk of mortgage-backed securities and award credit ratings that help determine the market price for the security. However, rating agencies make no determination about "the suitability of the underlying loans for individual borrowers."[8] Instead, rating agencies are concerned with whether the pool will perform overall and deliver the return promised to investors for the agreed-upon price. At the end of the day, there is one party always "on the hook" for a mortgage default: the homeowner.

Investor Demand for Dangerous Products: 2/28 "Exploding" ARMs

During the past few years, Wall Street became enamored with subprime mortgages. Subprime-backed investments worked well for the market when housing appreciation was high, but Wall Street's demand for subprime volume continued in spite of widespread warnings about a slow-down in housing appreciation. To feed growth in the market, lenders loosened underwriting guidelines and developed more dangerous products, and Wall Street continued to accept these loans.

Subprime lenders have indicated that the types of products they offer and how they underwrite them are largely investor-driven. Consider the frank acknowledgement by the chief executive of Ownit Mortgage Solutions, a state-licensed non-bank mortgage lender that filed for bankruptcy protection after investors asked it to buy back well over one hundred million dollars worth of bad loans. According to the *New York Times*, Ownit's chief executive, William D. Dallas "acknowledges that standards were lowered, but he placed the blame at the feet of investors and Wall Street, saying they encouraged Ownit and other subprime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. '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?'"[9]   Similarly, an article from yesterday's *Washington Post* shows, at the ground level, the impact that investor demand has had in the actions of one company, New Century, in encouraging abusive lending.[10]

The major way lenders fed demand for subprime loans was by offering dangerous hybrid adjustable-rate mortgages (ARMs), which they continue to offer today. These loans start with deceptively low monthly payments, even though those payments are certain to increase at the end of an initial period, usually two years. As a result, these loans result in significant "payment shock," meaning that the homeowner's monthly payment quickly skyrockets to an unaffordable level.

Unfortunately, payment shock is not unusual, but represents a typical risk that comes with the overwhelming majority of subprime home loans. (For a specific example of payment shock, see the Appendix.) Today the dominant type of subprime loan is a hybrid mortgage called a "2/28" that effectively operates as a two-year "balloon" loan.[11] This ARM comes with an initial fixed teaser rate for two years, followed by rate adjustments in six-month increments for the remainder of the term of the loan.[12] Commonly, this interest rate increases by between one-and-a-half and three percentage points at the end of the second year, and such increases are scheduled to occur even if interest rates in the general economy remain constant; in fact, the interest rates on these loans generally can only go up, and can never go down.[13]   This type of loan, as well as other similar hybrid ARMs (such as 3/27s) have rightfully earned the name "exploding" ARMs. Hybrid ARMs (2/28s and 3/27s) and hybrid interest-only ARMs have become "the main staples of the subprime sector."[14] Through the second quarter of 2006, hybrid

ARMs made up 81 percent of the subprime loans that were packaged as investment securities. That figure is up from 64 percent in 2002.[15]

While teaser rates already make the borrower's monthly payment artificially low, many subprime lenders also do not escrow for taxes and insurance. Subprime lenders often tout their low monthly payments without disclosing that the failure to escrow is the reason for much or all of the "discount" over the monthly payments offered by responsible lenders who do escrow. This creates a trap for borrowers who cannot afford the tax and insurance bill when it comes due, and makes it virtually impossible for responsible lenders, whose payments include escrows, to compete. A recent study by the Home Ownership Preservation Initiative in Chicago found that among low-income borrowers facing difficulty in managing their mortgage payments, for as many as one in seven, tax and insurance payments are a contributing factor.[16]

Because of the proliferation of hybrid ARMs with dangerous features, payment shock for subprime borrowers is a serious and widespread concern. According to an article in the financial press that ran a year ago, homeowners face increased monthly payments on an estimated $600 billion of subprime mortgages that will reset after their two-year teaser rates end.[17] Fitch Ratings calculated that by the end of 2006, payments would have increased on 41 percent of the outstanding subprime loans.[18]

It is clear that mortgage investors have been a driving force behind the proliferation of abusive loans in the subprime market. These loans had extremely high prepayment rates caused by the scheduled payment shock—very few families could afford a 30 to 40 percent increase in their mortgage payment. In addition, since the monthly payment often failed to include payments for taxes and insurance, families that were stretched financially had difficulty coming up with these large lump sums every year. When housing appreciation was climbing, most borrowers refinanced before the payment shock hit—in fact, they were likely heavily solicited by brokers and subprime lenders to do so.

This high loan turnover accomplished several objectives for ratings agencies, investment banks, and investors. First, investors crave predictability of income streams above all else, and the average life of these loans was extremely short—recent cash flow assumptions from Fitch Ratings carry an assumed average loan life of two and one-half years for the most common variety of subprime ARM loans.[19] Second, investors in the so-called P-classes received significant income from prepayment penalties paid by borrowers forced to refinance. Third, ratings agencies and investment banks received significant fees upon each refinancing. Brokers and lenders benefited too, since they are paid at each origination.

The only actor that doesn't benefit from these market dynamics, of course, is the family receiving the loans. Even under a best-case scenario, where the borrower is in an area with substantial property appreciation and is thus able to refinance, he or she will need to pay the costs of getting a new loan. The refinance can cost three percent in up-front points and fees, up to two percent in third-party fees, and about three percent in a prepayment penalty on the old loan if the refinancing is not timed just right, adding up to eight percent of the loan amount. Based on current rate sheets that detail lenders' mortgage prices, a family saves only 65 basis points a year to get a hybrid ARM versus a fixed rate mortgage,[20] a loan they could potentially stay in for 30 years, saving 1.3 percent over two years. On a $200,000 mortgage, the 6.7 percent needlessly expended constitutes $13,000 in wealth stripped from the family simply because they were placed in a loan that they had no prospect of staying in versus one that they could maintain. Of course, if housing does not appreciate or declines, the family instead faces the very real prospect of losing their house to foreclosure.

III. Incentives Remain for Investors to Gamble on Families' Homes

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

In fact, dangerous products remain a staple in the market despite the lessons of recent months. One of the key findings in CRL's foreclosure report ("Losing Ground," cited above) is that subprime mortgages typically include characteristics that significantly increase the risk of foreclosure, regardless of the borrower's credit profile. Our findings are consistent with other studies, and show what responsible lenders and mortgage insurers have always known: increases in mortgage payments after origination and poorly documented income substantially boost the risk of foreclosure. For example, even after controlling for differences in credit scores, adjustable-rate mortgages had 72 percent greater risk of foreclosure than fixed-rate mortgages

In spite of the known risks, subprime lenders are continuing to originate highly dangerous loans, and Wall Street is continuing to accept these loans. A review of five mortgage-backed securities offered in the first quarter of 2007 reveals that loans containing features shown to increase the risk of foreclosure continue to constitute a large portion of subprime offerings. The chart below compares the higher risk associated with certain products with the prevalence of those terms in these 2007 offerings.

Dangerous Products Remain Staples in the Subprime Market

	Increased likelihood of foreclosure[15] (2000 vintage subprime originations)	Penetration rate of these high-risk loan features in five 2007 MBS offerings, (average).[16]
ARM	72% (117% - 2003 vintage)	82%
Prepayment penalty	52%	72%
Stated income	29% (64% - 2003 vintage)	43%

The proportion of product features that have been demonstrated to increase foreclosures in the subprime marketplace, compared to their relative infrequency in the prime market, belies any assertion that subprime borrowers freely and knowingly "choose" these riskier terms. These products and terms are supply-driven, not demand-driven, frequently promoted to satisfy originator and investor appetite for loans that regularly refinance and for higher-yields.

As foreclosure rates rise to alarming levels, investors are looking more closely at underwriting practices that have produced foreclosure rates far higher than predicted, and in some instances investors have demanded the repurchase of loans that defaulted extremely quickly. In a few highly publicized cases, lenders have been forced out of business as a result.[21] However, defaults that occur after a designated three-to-six month period are not generally the responsibility of the lender. And while recent investor attention may force lenders to make some adjustments to accommodate investor concerns, it will not help those borrowers who are in 2/28s now, many of whom will lose their homes, their equity and their credit ratings when lenders foreclose on loans that never should have been made.

IV. Accountability for Loan Quality: Assignee Liability

One readily available approach for holding investors accountable for their role in driving the lending market is "assignee liability."[22] 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. Assignee liability would help ensure that when investors accept mortgages, with all the corresponding financial benefits, that they also accept reasonable liability for when the mortgages prove to be abusive and harm homeowners. Assignee liability would not only protect borrowers, but would also assist in preserving the integrity of the secondary market.[23]

Since three-quarters of subprime home loans are sold on the secondary market,[24] assignee liability is a critical tool for addressing abusive mortgage lending practices. Without legal liability for assignees, a family that has been the victim of a predatory loan cannot stop the foreclosure of their home even if the originator is solvent and well-capitalized.

Instead, they end up losing their home, and then they must bring a separate action against the originator. This separate action can take years.

Assignee liability is even more important in light of the substantial involvement of mortgage brokers and other minimally capitalized originators who frequently go out of business before a homeowner recognizes a predatory loan.[25] For mortgage loans sold or otherwise assigned after closing, the party collecting and enforcing the note is not the one that the borrower dealt with and who originated the loan. In fact, while relatively few home loans were brokered ten years ago, about seventy percent of subprime mortgages are broker-originated today.[26]

Assignee liability also helps to protect responsible investors from misperceived risks and provides incentives for the market to police itself, curbing market inefficiencies. No one is more effective than investors who face financial and legal risk in ensuring that loans are originated to specified standards. Without assignee liability, an unscrupulous lender can increase the value of the loans it sells by engaging in predatory practices and packing the loan with unnecessary fees, excessive interest rates and large prepayment penalties. The lack of assignee liability provides little incentive to purchasers of such loans to determine if the loans were originated illegally or are so out of line with market norms that they present a substantial likelihood of abuse.

Assignee Liability in Context: A Common Component of Consumer Protection Law
Assignee liability is not a new concept; it exists in several other contexts related to lending. 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 instance, an assignee may not be considered a holder-in-due-course (and thus be entitled to enforce a promissory note without regard to a consumer's claim) if the assignee purchased a delinquent loan.[27] Furthermore, even a holder-in-due-course is subject to certain claims, including defenses based on duress, lack of legal capacity, illegality of the transaction, or fraud.[28]

HOEPA itself provides for assignee liability in two instances. First, in instances where a homeowner did not receive the material disclosures required by HOEPA, the homeowner may rescind the loan (tender the principal owed on the loan and receive in return all interest and fees paid on the loan), even after it has been assigned.

Second, HOEPA provides that assignees of HOEPA high-cost home loans are subject to "… all claims and defenses … that the consumer could assert against the original creditor…."[29] In instances where assignees are held liable pursuant to this provision, damages are capped at "the greater of (1) the applicable TILA damages or (2) elimination of the loan and recovery of all payment made."[30] In other words, without time limits apart from those governing the underlying cause of action, an assignee may be liable for damages equal to amounts owed plus all amounts paid on the loan, including amounts paid before it took assignment of the loan. The only exception to this strict liability lies in instances where an "assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence, could not determine … [that the loan was a HOEPA high-cost home loan]."[31]

HOEPA's legislative history provides the following helpful explanation of the motivation for and desired effect of this provision:

> By imposing assignee liability, the Committee seeks to ensure that the High Cost Mortgage market polices itself. Unscrupulous lenders were limited in the past by their own capital resources. Today, however, with loans sold on a regular basis, one unscrupulous player can create havoc in a community by selling loans as fast as they are originated. Providing assignee liability will halt the flow of capital to such lenders.[32]

As one would expect, when faced with potential liability, assignees have developed techniques that limit their exposure. For example, in virtually every sale, loan purchasers protect themselves through representations and warranties that require the seller of the loans to indemnify the purchaser for all liabilities arising from the loans. Investors also conduct due diligence, such as loan sampling, to verify the integrity of the loans they are buying. Moreover, individual investors in securities backed by subprime home loans retain confidence since they have no individual liability under any assignee liability schemes designed by HOEPA or in the states since, as investors in securities, they are not "holders" or "assignees" of the individual loans and consequently may not be sued.

State Laws Strike a Balance

Building on HOEPA's initial statement of assignee liability for high-cost home loans, states such as North Carolina, New Jersey, New Mexico, New York, Illinois, Massachusetts, and Rhode Island have developed and implemented provisions that establish different levels of assignee liability for investors, depending on whether they intentionally purchase high-cost loans as defined by those state laws. The provisions in those states attempt to satisfy several goals at once, balancing the interests of borrowers and investors. In short, they seek to (1) provide a clear incentive for the secondary market to conduct due diligence to prevent the unintentional purchase of high-cost home loans, (2) ensure that homeowners being foreclosed on or otherwise suffering harm arising from a predatory loan can defend their home, and (3) cap liability at the amount of the loan plus costs and prohibit class action lawsuits against good faith secondary market participants that unintentionally purchase a high-cost home loan.[33] They demonstrate that it is possible to strike a balance between having appropriate liability and addressing secondary market concerns.

Other than the prohibition against loan flipping, which has not been effective because the 2/28 defective product design leads to serial refinances, it appears that state anti-predatory lending laws are having their intended effects at curbing the abusive mortgage terms they targeted. The Center for Responsible Lending examined this issue specifically in research issued last year in which we examined 28 state reforms by analyzing six million subprime mortgage loans made over a seven-year period. We found that in states with anti-predatory lending laws that go beyond current federal protections, borrowers get fewer loans with abusive terms without losing access to mortgage credit.[34]

Typically, rating agencies responded to state assignee liability provisions by requiring extra credit enhancements in pools that included high-cost mortgages covered by such state laws. The credit enhancement requirement may have forced lenders to hold high-cost loans in their portfolios. In effect, then, assignee liability provisions discouraged lenders from making unnecessary high-cost loans while allowing those loans that truly merit high-cost pricing to be made by lenders with sufficient financial strength to stand behind their loans—exactly the outcome desired by those who have supported strong anti-predatory lending laws. It is also worth noting that the subprime market experienced extraordinary growth during recent years, when many states were strengthening anti-predatory laws, including, in some cases, stronger assignee liability provisions. Approximately two dozen states took action to give consumers stronger protections against subprime loans from 1998 through 2005 – the same period when the share of subprime mortgages increased from just three percent of the total market to over 20 percent.

V. Preventing Foreclosures and Improving Loan Quality – Leadership Urgently Needed

In addition to Congress preventing abusive originations in the future by holding the secondary market accountable, the secondary market also has an opportunity to play a role in limiting the damage caused by abusive loans that have already been made. Investors will have tremendous influence in how many more losses are suffered in the subprime market. As stated recently by an executive of Countrywide Mortgage, "The investor 'owns' the loan and determines which options are available to borrowers in default, while the mortgagor, the "servicer," maintains the loan on behalf of the investor."[35]

It is critical that investors support servicers that are modifying existing subprime loans or lenders that are offering constructive refinances by purchasing these loans under attractive terms. This point was underscored recently when the Committee on Banking, Housing, and Urban Affairs, led by Senator Dodd, issued principles for preserving ownership for families who are now struggling with hybrid ARMs. The principles included a number of strategies for assisting homeowners in distress, including early contact and evaluation by loan servicers, low-cost refinancing to prime loans, and various options for modifying mortgages to create sustainable financing.[36] For borrowers facing an unaffordable increase in payments due to the scheduled reset of a 2/28 mortgage, a no-cost modification is the best solution.

There is an emerging consensus that servicers have the ability under the vast majority of Pooling and Servicing Agreements, IRS REMIC (Real Estate Mortgage Investment Conduit) rules, and accounting standards to proactively modify loans whenever they determine in good faith that it is reasonably foreseeable that the borrower will default. A recent Credit Suisse report found that agreements "give servicers wide leeway in working with borrowers" and "most servicing documents have few restrictions on loan modifications."[37] In fact, some servicers are already calling borrowers six months before rates are scheduled to reset to make sure that they are aware of this fact and to determine whether they will be able to handle the payment shock.[38]

We are heartened by an announcement made just last week that Moody's Investors Service is considering taking a major step to encourage loan modifications on subprime loans headed for foreclosure. Specifically, Moody's would essentially penalize mortgage-backed securities that restrict the number of loans that can be modified. This is welcome news, especially since Moody's rates more than 90 percent of subprime mortgage-backed securities.[39] We hope other rating agencies will follow suit and explore other ways they can encourage servicers and lenders to offer borrowers responsible loan modifications.

While it is clear that servicers will modify substantial numbers of loans facing reset, it is much less clear that these modifications will enable families to remain in their homes for the life of the loan.

We have heard reports that servicers are simply delaying the 2/28 reset for two years, placing the borrower right back where they started two short years later. The 2/28 is an irresponsible loan, and delaying the problem for two years is not what is needed. Instead, servicers should make the loan permanently affordable for the borrower by, for example, extending the teaser rate for the life of the loan, and/or reducing the interest rate and/or the principal balance.

Investors as a whole win when the servicer ensures a steady, even if lower, stream of principal and interest payments, since loss severity in a stable or declining property value environment, particularly given the epidemic of overstated appraisals, will often exceed 50 percent of the value of the loan. Investors have sound economic reasons to encourage servicers to engage in widespread permanent loan modification programs or low-cost refinance efforts. And, given that investors participated in and benefited from placing borrowers in highly unsuitable loans, they certainly have an obligation not to stand in the way of constructive efforts to repair abusive loans.

The Government-Sponsored Enterprises (GSEs)

Not all of the support for 2/28s came from private Wall Street firms. Even though Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSEs), have a mandate to help families achieve homeownership, and over the years have made a significant contribution, they, too, purchased subprime securities backed by loans that were made without considering low- and moderate-income families' ability to repay.

In February, however, Freddie Mac took an important step by announcing it would no longer purchase mortgage-backed securities backed by abusive subprime loans. In addition, both Fannie Mae and Freddie Mac recently announced substantial commitments to helping borrowers who are facing subprime rate resets.[40]

Finally, although data is hard to come by, I believe that Federal Home Loan Banks (FHLBs) have continued to fund subprime loans that are likely abusive. Enabling subprime lenders to hold these loans in portfolio through their advance program is functionally equivalent to purchasing the loans, and therefore equally problematic. The Federal Housing Finance Board or Congress should impose more demanding anti-predatory lending guidelines on FHLB advance programs, just as HUD and Ofheo have done for Fannie Mae and Freddie Mac mortgage purchases.[41]

Rating Agencies

As discussed above, mortgage investors have been a driving force behind the proliferation of abusive loans in the subprime market. Their high demand for these mortgages has encouraged lax underwriting and the marketing of unaffordable loans as lenders sought to fill up their coffers with loans that could be easily resold**,** despite a high likelihood of foreclosure. For example, approximately 80 percent of subprime mortgages included in securitizations issued during the first nine months of 2006 carried an adjustable-rate feature, the majority of which are 2/28s.[42] Yet, until very recently**,** the rating agencies raised no red flags about securities backed by subprime mortgages. We urge the rating agencies to develop stronger internal policies to screen for and guard against abusive loans, and to give weight to origination and servicing practices that provide sustainable homeownership opportunities.

Securities and Exchange Commission

Given that the securities market is regulated by the Securities and Exchange Commission (SEC), that agency has an opportunity to take an active role in preserving homeownership among subprime borrowers today. The SEC should join other federal and state regulatory agencies in urging lenders and servicers to work with borrowers to modify unsustainable loans so that borrowers can keep their homes for the life of the loan. The SEC should also make public its efforts to investigate Wall Street's role in the current foreclosure crisis, and offer a proposal for working with industry to provide immediate relief to the millions of families at risk of losing their homes.

Conclusion

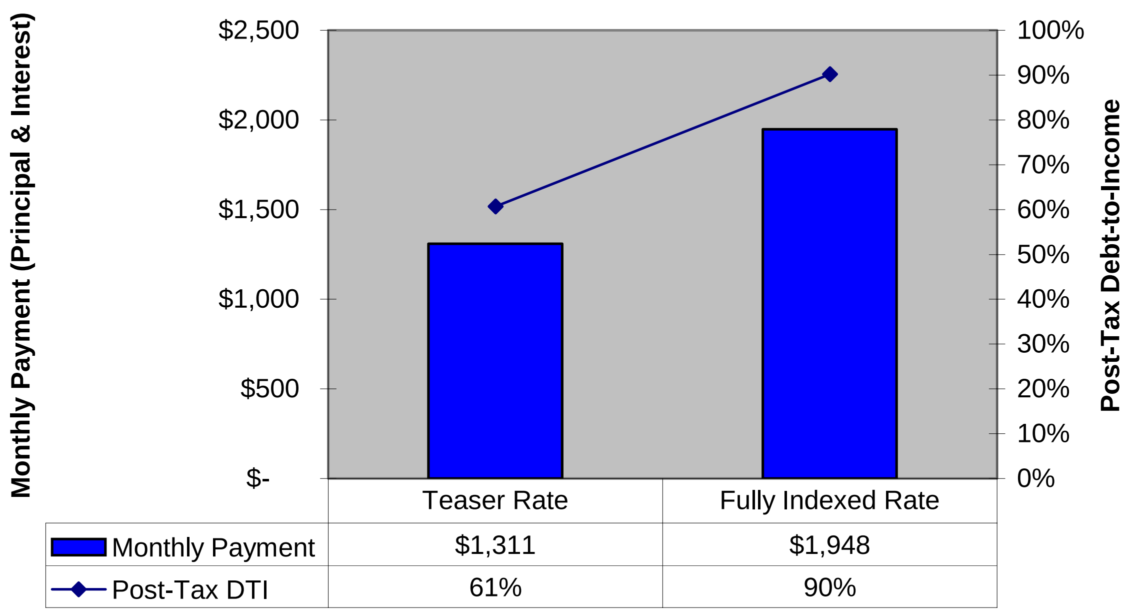
Subprime lending and the secondary market involve many complexities, but it is important to bear at mind that the fundamental policy issue is sustainable homeownership for families. The rest is just a means to an end. Whether families achieve lasting ownership has huge implications for the future economic health of our nation. The current situation has produced neither sustainable profits nor sustainable ownership, and the losses have adverse consequences for all parties involved. Both Wall Street and homeowners stand to lose from a market that offers unsustainable loans. Placing incentives on the secondary market to self-police the loans it buys is one of the best possible ways to ensure that families receive loans that they can keep.

APPENDIX

Payment Shock

Let me provide an example of the severity of payment shock that can occur on the typical exploding ARM for a $200,000 loan:

Subprime Adjustable Rate Mortgage Payment Shock
(No Change in Interest Rates)



For the 2/28 ARM shown in the chart above, we are making conservative assumptions that correspond with typical mortgages of this type. To make the example even more conservative, we are assuming no general increase in interest rates, even though rates have increased substantially in the past three years. The example is based on an introductory teaser rate of 6.85 percent and a fully indexed rate of 11.50 percent.[43] The loan amount used in this example was $200,000, and, given the common practice of extending loans where the pre-tax debt-to-income ratio is 50 to 55 percent, we assume that this homeowner had a pre-tax income of $31,452, which equates to a post-tax income of $25,901.

At the end of the introductory rate period, this homeowner's interest rate rose from 6.85 percent to 9.85 percent, and the monthly payments jumped from $1,311 to $1,716, and again six months later to $1,948, an increase of over $600 a month.[44] This would be a large increase for most families, and is a huge burden for a family that already struggles with debt. At $1,948, this leaves only $210/month for all other expenses – including property taxes and hazard insurance, food, utilities, transportation, healthcare, and all other family needs.

All too commonly, this hypothetical homeowner had credit scores that would have qualified him or her for a fixed rate loan at 7.5 percent, which would have translated to monthly payments of $1,398—a challenging debt-load to be sure, but far more sustainable than the $1,948 fully-indexed monthly payment associated with the 2/28 loan illustrated above, a payment that can easily increase as interest rates rise.

NOTES

[1] A full copy of the "Losing Ground" foreclosure study and an executive summary appear on CRL's website at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189.

[2] Mortgage Finance Industry Overview, Lehman Brothers Equity Research, p. 4 (December 22, 2006).

[3] *Inside B&C* Lending (Sept. 1, 2006); *see* also *Inside Mortgage Finance* – MBS Database, 2006.

[4] Nearly 55 percent of African Americans who purchased homes in 2005 received higher-rate loans; 49 percent received such loans to refinance their homes. Slightly more than 46 percent of Latino borrowers received higher-rate purchase loans; about 34 percent received higher-rate refinance loans. See CRL internal analysis of HMDA data, www.responsiblelending.org/pdfs/HMDA-Comment-9-28-06.pdf.

[5] By comparison, corporate bonds accounted for 20 percent of the market, and Treasury debt accounted for another 16 percent. *U.S. Bond Market Debt*, Bond Market Association (June 30, 2006) at http://www.bondmarkets.com/assets/files/Outstanding%20Level.pdf.

[6] According to the Mortgage Bankers Association, mortgage brokers now originate 45% of all mortgages, and 71% of subprime loans. MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006.

[7] Ren S. Essence 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 .

[8] Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending* (June 19, 2006) at SSRN: http://ssrn.com/abstract=910378.

[9] Vikas Bajaj and Christine Haughney, *Tremors At the Door -- More People with Weak Credit Are Defaulting on Mortgages*," New York Times (Fri. Jan. 26, 2007) C1, C4.

[10] David Cho, *Pressure at Mortgage Firm Led to Mass Approval of Bad Loans*, Washington Post (May 7, 2007).

[11] A balloon loan is one that is not repayable in regular monthly installments, but rather requires repayment of the remaining balance in one large lump sum. While 2/28s are not balloon loans, the impact of higher interest rates at the end of the two-year teaser rate period, resulting in higher monthly payments, may force a borrower to seek refinancing.

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

[13] Here we are describing the 2/28 because it is by far the most common product in the subprime market, but the concerns are the same with the 3/27, which differs only in that the teaser rate remains in effect for three years.

[14] *See Structured Finance*, note 12.

[15] *See Structured Finance*, note 12.

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

[17] Jonathan R. Laing, *Coming Home to Roost*, p. 26 Barron's, February 13, 2006.

[18] *See Structured Finance*, note 12.

[19] Fitch Ratings, U.S. RMBS Intex-based Cash Flow Model (last verified Feb. 7, 2007).

[20] The industry itself has acknowledged that borrowers placed in subprime hybrid ARMs could have received fixed-rate loans, with a rate difference that is "commonly in the 50 to 80 basis point range:" indeed, often a fixed rate loan can have a lower interest rate and monthly payments than a stated income exploding ARM loan. January 25, 2007 letter from CFAL to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3. A review of rate sheets from eight subprime lenders showed that the fixed rate premium in the spring of 2007 ranged from 40 basis points (available with a 3-year prepayment penalty) to 75 basis points. *See, e.g.* Appendix B, October, 2006 rate sheet with a 65 basis point fixed rate premium.

[21] Patrick Crowley, *Repurchases Stinging Subprime Sector*, MortgageDaily.com (Jan. 5, 2007). See also, "Subprime Status Report," American Banker (April 2007).

[22] An "assignee" is a party who purchases or otherwise takes a financial interest in the loan. The assignee has the right to collect payments and enforce the terms of the loan, including foreclosing on a house if a borrower defaults.

[23] Recently Harvard issued a study that also recommended lifting current restrictions on assignee liability – see note 7.

[24] *Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market* (April 2, 2007), cited by Sheila Bair, Chair, Federal Deposit Insurance Corporation in a statement to the Committee on Financial Services, U.S. House of Representatives (April 17, 2007).

[25] Borrowers seeking a remedy find that brokers typically have substantially fewer assets than lenders (one recent study put the average size of brokerages at ten employees) and are more likely to go out of business and be judgment-proof. *See* Wholesale Access, "New Research About Mortgage Brokers Published," (August 6, 2003) (available at: http://www.wholesaleaccess.com/8.6.03.mb.shtml) and Eggert, Kurt, "Held Up in Due Course: Predatory Lending , Securitization, and the Holder in Due Course Doctrine," Creighton Law Review, v35, n3 (April 2002).

[26] See note 6.

[27] *See e.g.*, NCGS 25-3-302 (detailing this and other prerequisites to holder-in-due-course status).

[28] *See e.g.*, NCGS 25-3-305(a)(1).

[29] 15 U.S.C. 1641(d).

[30] *See e.g.*, In re Murray, 239 B.R. 728, 733 (Bkrtcy. E.D. Pa. 1999) (applying damages cap from 15 U.S.C. 1641(d)(2) and 15 U.S.C. 1641(d)(3)).

[31] 15 U.S.C. 1641(d)(1).

[32] S. Rep. No. 103-169, at 28 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1881, 1912.

[33] For example, under New Jersey's existing law, we estimate that the likelihood that an assignee who inadvertently purchased a high-cost home loan would face exposure is one in a million. The chances are this low because, in order for a good-faith loan assignee to face exposure on a given loan, all of these events must occur: (1) A high cost loan is purchased in spite of due diligence; (2) the loan contains a clear violation; (3) the borrower successfully prosecutes a claim; and (4) the seller of the loan is insolvent and can't indemnify the assignee.

[34] Wei Li and Keith Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending (February 23, 2006), available at www.responsiblelending.org.

[35] Jerry Durham, Vice President – Homeownership Preservation, Countrywide, "Preserving the Dream of Homeownership," presentation dated May 6, 2007.

[36] United States Senate, Committee on Banking, Housing and Urban Affairs, "Homeownership Preservation Summit—Statement of Principles (May 2, 2007).

[37] Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications, Fixed Income Research* (April 5, 2007), available at http://www.credit-suisse.com/researchandanalytics.

[38] See, e.g., "Option One Mortgage Corporation Announces Support of the Senate Banking Committee's Principles for Mortgage Servicers," press release issued by Option One Mortgage Corporation (May 4, 2007).

[39] Jody Shenn, "Moody's May Penalize Subprime Bonds that Cap Changes," Bloomberg (April 25, 2007).

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http://www.fanniemae.com/media/speeches/speech.jhtml;jsessionid=QHTBFLCBO5TAZJ2FQSHSFGA?repID=/media/speeches/2007/speech_267.xml&counter=1&p=Media&s=Executive+Speeches; http://freddiemac.com/news/archives/corporate/2007/20070418_subprime_commitment.html

[41] See Testimony of Martin Eakes before the Committee on Banking, Housing and Urban Affairs, Hearing on the Federal Home Loan Bank System, April 13, 2005, http://www.responsiblelending.org/pdfs/041305-EakesTestimony.pdf at 11-15.

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

[43] The typical 2/28 rises to 6-month LIBOR (now 5.35 percent) plus an index of 6.5 percent, or almost 12 percent.

[44] Typically the rate increase at the first adjustment is capped somewhere between 1.5 and 3 percentage points. On this loan, the rate reached the fully indexed rate at the second adjustment two-and-a-half years into the loan.