COMMENTS

On

PROPOSED INTERAGENCY
STATEMENT ON SUBPRIME MORTGAGE LENDING

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VIA ELECTRONIC MAIL

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The Center for Responsible Lending[1] submits the following comments on the proposed Interagency Statement on Subprime Mortgage Lending.

I. Introduction.

We strongly support the Interagency Statement on Subprime Mortgage Lending and voice our appreciation for the essential step toward responsible subprime lending that the agencies' action represents. We urge the agencies to finalize the Statement without any weakening of the essential underwriting components. It will encourage originators to return to more responsible underwriting practices and give borrowers a better chance to receive loans that will provide sustainable homeownership opportunities. We agree that it is absolutely critical that an institution's analysis of repayment capacity must include an evaluation of their ability to repay the debt by final maturity at the fully indexed, fully amortized rate.[2] We also urge strengthening the Statement, especially as it relates to assessment of the ability to pay standards, verification of income, and requiring escrow of tax and insurance.

We welcome the agencies' efforts to restore sound underwriting guidelines to an all-too-large segment of the subprime mortgage market consisting of dangerous products, inadequately underwritten, with insufficient regard to the borrower's ability to repay. Not surprisingly, the default rate in these products is high, with the result that 2.2 million families with loans originated between 1998 and 2006 have lost or will lose their homes through foreclosure.[3]

This dark side of the subprime marketplace shows that claims that subprime lending has expanded homeownership are not justified. The number of families who have lost or will lose their homes is nearly *1 million more* than the number of new homeowners created through subprime mortgage lending over the same period.[4] These losses may not be

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[1] The Center for Responsible Lending is dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. A non-profit, non-partisan research and policy organization, CRL promotes responsible lending practices and access to fair terms of credit for low-wealth families. CRL is affiliated with the Center for Community Self-Help, one of the nation's largest non-profit community development financial institutions.

[2] We recognize that in a rising rate environment such as the recent one, unmanageable payment shock may occur even in the absence of an initial teaser rate on the loan. For example, the 6-month LIBOR, a standard index used in subprime 2/28s, rose from 1.17% in March, 2004 to 4.56% in March, 2006, and 5.33% in March, 2007. (LIBOR rates available at http://www.bba.org.uk/content/1/c4/84/51/Mar07.xls) For that reason, there are proposals that call for a stronger underwriting touchstone, such as the maximum rate which the loan could reach within a specified number of years, *see, e.g.* S. _____, "Borrower's Protection Act of 2007," introduced by Sen. Schumer on May 4, 2007.

[3] Ellen Schloemer, Wei Li, Keith Ernst and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* (Center for Responsible Lending, December, 2006), http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf ("*Losing Ground*") at 3.

[4] *Subprime Lending: A Net Drain on Homeownership*, CRL Issue Paper No. 14, Center for Responsible Lending, (March 27, 2007), available at: http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf

easily reversed, particularly for those who lost their first home. A HUD study reported that first-time homebuyers who leave homeownership may take a decade to re-enter homeownership, fourteen years for minority families.[5]

These devastating losses demonstrate that the mortgage market cannot be relied upon to correct itself before the damage is done. Perverse incentives rewarded irresponsible lending, and made it more difficult for responsible lenders to compete. The market encouraged loan originators to place borrowers into dangerous hybrid adjustable rate mortgages (ARMs) with large built in payment shock, even when they qualified for sustainable fixed-rate loans at little or no cost increase. These practices continued long after the hazards for borrowers had become obvious. Regulatory engagement is therefore essential.

While the proposed Statement takes a crucial step forward in identifying and reducing many of the too-prevalent abusive practices for the future, the legacy of their past remains in the current crisis. Therefore, though it is beyond the scope of the proposed statement, we also urge the agencies to take a leadership role in encouraging industry, including lenders, servicers, and investors, to promote a comprehensive foreclosure prevention strategy to assist borrowers whose homes and financial security have been imperiled by the irresponsible lending practices that have prevailed to date. The agencies' recent statement encouraging financial institutions to work with borrowers[6] and the Federal Deposit Insurance Corporation's recent roundtable of stakeholders and continuing efforts provide a welcome start.

II. Inappropriate and unsound lending practices have dominated the subprime mortgage market.

Unfortunately, the potential benefits of expanded access to credit are not what they could have been in a rational market. The products dominating the market in recent years have aggravated, rather than mitigated, whatever risk inheres in making loans to credit-challenged families. Subprime lenders routinely marketed the most dangerous loans to the most vulnerable families and those already struggling with debt.

- Adjustable rate mortgages ("ARMs"), especially those structured with built-in payment shock, are associated with elevated risk of failure. And yet, rather than offer these products judiciously, subprime lenders have made short-term hybrid ARMs (2/28s and 3/27s) and interest-only hybrid ARMs "the main staples of the subprime sector."[7] Indeed, through the second quarter of 2006, hybrid ARMs

[5] Donald R. Haurin and Stuart S. Rosenthal *The Sustainability of Homeownership: Factors Affecting the Duration of Homeownership and Rental Spells,* p. 43 HUD Office of Policy Development, (December, 2004), at http//www.huduser.org/Publications/pdf/homeonwsustainability.pdf.

[6] Interagency Statement on Working With Borrowers, (April 17, 2007), *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2007/20070417/default.htm

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

made up 81 percent of the subprime loans sold as investment securities on the secondary market.[8]

- Common to the subprime sector is the needlessly hazardous practices of failing to escrow for taxes and insurance.[9] Subprime lenders often tout their low monthly payments without disclosing that the failure to escrow is what accounts for much or all of the phantom savings over monthly payments offered by responsible lenders who do escrow. This creates a trap for borrowers who cannot afford the tax and insurance bills when they come due. It also makes it impossible for responsible lenders, whose payments include escrows, to compete.

- Steering borrowers away from conventional loans for which they would have qualified into higher-priced, more dangerous loans, put as many as 1 in 5 families needlessly at risk.[10]

- Exacerbating all such core problems has been an epidemic of weakened underwriting.[11] Failing to apply prudent underwriting standards to loans is a

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[8] *Id.* That figure is up from 64 percent in 2002. *Id.*

[9] *See, e.g. Partnership Lessons and Results: Three Year Final Report*, p. 31 Home Ownership Preservation Initiative (July 17, 2006), at www.nhschicago.org/ (noting the relationship of tax and insurance obligations to difficulty in managing mortgage payments among lower-income borrowers.)

[10] A Freddie Mac researcher reports one out of five subprime borrowers could qualify for prime loans, (*see* Mike Hudson and E. Scott Reckard, *More Homeowners with Good Credit Getting Stuck in Higher-Rate Loans*, L.A. Times, p. A-1 (October 24, 2005)), and a lending industry association recently acknowledged that many borrowers placed into 2/28 mortgages could have qualified for thiry-year, fixed rate loans for a rate typically just 50 to 80 basis points (i.e., .5 or.8 of a percent) higher than the teaser rate on the loan they received. (s*ee* February 5, 2007 letter from CRL to Senators Dodd, Allard, Schumer, Reed and Bunning, attached as an exhibit to the Testimony of Martin Eakes before the U.S. Senate Committee on Banking, Housing and Urban Affairs, at p. 7 (responding to claims made by the Coalition for Fair and Responsible Lending (CFAL)), available at http://www.responsiblelending.org/pdfs/martin-testimony.pdf).

[11]See e.g., Office of the Comptroller of the Currency, National Credit Committee, *Survey of Credit Underwriting Practices 2005.*The Office of The Comptroller of Currency (OCC) survey of credit underwriting practices found a "clear trend toward easing of underwriting standards as banks stretch for volume and yield," and the agency commented that "ambitious growth goals in a highly competitive market can create an environment that fosters imprudent credit decisions." In fact, 28% of the banks eased standards, leading the 2005 OCC survey to be its first survey where examiners "reported net easing of retail underwriting standards." *See also* Fitch Ratings, 2007 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis (December 11, 2006); David Cho, "*Pressure at Mortgage Firm Led to Mass Approval of Bad Loans", The Washington Post* (May 7, 2007), available at: http://www.washingtonpost.com/wp-dyn/content/article/2007/05/06/AR2007050601402.html?hpid=topnews ("We were constantly told, 'If you look the other way and let an additional three to four loans in a day that would mean millions more in revenue for New Century over the course of the week, … .[n]o one, from the top levels down to the lower levels of the office, didn't want those loans to go through.")

recipe for failure in the best of circumstances. Doing so on loans laden with multiple risk features, as those described here, is a recipe for disaster.

These dangerous products remain a staple in the market despite the lessons of recent months.

Many in the industry now admit that they put short-term growth goals ahead of long-term sustainability.[12] It is precisely that recurring tendency that makes regulatory action appropriate, particularly in light of evidence of continued reluctance to rein in some of these practices.[13]

A review of five mortgage-backed securities offered in the first quarter of 2007 indicates 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 continued prevalence of those terms in these 2007 offerings.

Table 1: Risky Products Remain Staples in the Subprime Market

	Increased likelihood of foreclosure[14]	Penetration rate of these high-risk loan features in five 2007 MBS offerings, (average).[15]
ARM	72% (117% - 2003 vintage)	82%
Prepayment penalty	52%	72%
Stated income	29% (64% - 2003 vintage)	43%

[12] *See, e.g.* David Cho, "*Pressure at Mortgage Firm Led to Mass Approval of Bad Loans*", *The Washington Post* (May 7, 2007), available at: http://www.washingtonpost.com/wp-dyn/content/article/2007/05/06/AR2007050601402.html?hpid=topnews ("The head of a large Wall Street bank's mortgage group contended that his firm regularly lost out on New Century's business because its due diligence process was stringent and it had been returning a high number of loans. New Century wanted the bank to ease its standards, and the issue became a source of friction between the companies. 'The entire industry, over time, became more lax,…. The more [loans] you accepted, the better relationship and the better price you would have. The name of the game was definitely volume."); *See also* Jon Menon and Ben Livesey, *HSBC boosts set-aside for bad loans,* Chicago Sun-Times (February 9, 2007), (HSBC set aside $10.56 billion reserves; executive Brendan McDonah notes that HSBC "made the mistake of going for volume.")

[13] *See, e.g.* Jody Shenn, *Countrywide's Mozilo Says Regulators May Worsen Subprime Losses*, Bloomberg.com (April 23, 2007) (urging that troubled-loan refinances be exempted from these guidelines which, ironically, are designed to reduce the incidence of troubled loans.)

[14] Ellen Schloemer, et al, *Losing Ground:* supra note 3, at p. 21 . Unless otherwise stated, the increased odds of foreclosure are those for 2000 vintage subprime loans. The foreclosure trend line for more recent vintages are tracking 2000 originations. *Id* at 12.

[15] The identity of the offerings and a summary of the characteristics of each is attached as Appendix A.

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 hazardous 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.[16] Regulatory action must help counter those perverse market incentives.

III. The consequence: a foreclosure crisis, and catastrophic losses for borrowers, their families and their communities.

CRL's study of nine years of subprime lending, projecting that 1 in 5 subprime mortgages originating in 2005 and 2006 would end in the loss of the home to foreclosure, was released in December, 2006. Events since then provide evidence that this projection may be conservative: a recent Lehman Brothers study put the number of 2006-originated loans likely to end in completed foreclosure at 30%.[17]

As we discussed in Section II, it is not merely the weakened underwriting and the rising interest rates of the past three years that caused the subprime foreclosure crisis. There clearly have been fundamental weaknesses in these products from the beginning. For example, of 2000 vintage originations, 1 in 4 ½ loans had a foreclosure initiated at least once (22.9%), with 1 in 8 resulting in a completed foreclosure (12.9%). A 1 in 4 ½ failure rate is a clear signal of structural problems such as those identified in the preceding sections.[18]

The consequences of these long-standing problems in the subprime market surfaced in some areas before today's more widespread crisis. In Philadelphia, for example, as early as the period from 2000-2003, subprime foreclosure filings in one neighborhood reached 19% of the housing stock; citywide it was 68 per 1,000 owner-occupied households.[19] The devastating, concentrated impact on minority neighborhoods is visible in a map of

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[16] *See, e.g.* 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 (quoting William D. Dallas, the chief executive of Ownit Mortgage Solutions, which filed for bankruptcy protection after investors asked it to buy back over one hundred million dollars worth of bad loans, as stating: "The market is paying me to do a no-income-verification [i.e., "stated income"] loan more than it is paying me to do the full documentation loans … What would you do?").

[17] Lehman Brothers, *Mortgage Finance Industry Overview* (Dec. 22, 2006) at 1.

[18] The foreclosure trends for more recent origination years in the CRL foreclosure study are tracking the 2000 vintage trend line. *See* Losing Ground, *supra* note 3, at 12. The different interest rate environment prevailing in the early years of 2000 vintage is a clear indication that interest-rate resets in a rising rate environment are not the sole explanation for the long-standing cracks in the market.

[19] Ira Goldstein, *Lost Values: A Study of Predatory Lending in Philadelphia*, p. 57, 58 (The Reinvestment Fund, April 2007), *available at* http://www.trfund.com/resource/downloads/policypubs/Lost_Values.pdf

foreclosed loans originated by a former large subprime lender.[20] And in Chicago, the Woodstock Institute found in 2004 that "increases in high cost subprime mortgage lending have been the leading driver of skyrocketing foreclosure levels across the Chicago region."[21]

Subsequently, as underwriting standards across the market weakened and interest rates rose, the trend toward greater – and earlier[22] -- loan failures has accelerated. The cooling housing market means that more of these failed loans will now end in completed foreclosures,[23] and the problems are spreading geographically.

- One major subprime servicer reports that nearly 50% of its Ohio subprime portfolio is in REO, foreclosure, or 60 days delinquent status[24]

- In Hennepin County, Minnesota, sheriff foreclosure sales stayed within 30% of 1,100 per year for almost 20 years, until they skyrocketed to 3,000 in 2006. More worrisome yet, sheriff sales there in the first quarter of 2007 are double the first quarter of 2006. The Twin Cities metro area saw the number of foreclosure sales more than triple between 2000 to 2007, when there were 7,000 foreclosure sales, again, with the steep rise occurring in 2005-2006.[25]

- Iowa's subprime foreclosure rate has put it at the rank of number 3 or 4 since 2004, according to the MBA's data on foreclosure inventories.[26] Local data present a taste of what's to come elsewhere in a cooled housing market as those foreclosure filings turn into a tidal wave of sheriff's sales. Data compiled by the Polk County Recorder's office (Des Moines, Iowa) show a three-fold rise in

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[20] Id at p. 16, mapping Equicredit foreclosure filings in 2000-2003. That lender was among the top 15 subprime originators in 1997 and 1998.

[21] Dan Immergluck and Geoff Smith, *Risky Business: An Econometric Analysis of the Relationship Between Subprime Lending and Neighborhood Foreclosures*, Woodstock Institute (2004).

[22] *See, e.g. Fitch: Risk-Layering Cause of Recent Subprime Defaults,* Inside B&C Lending (April 20, 2007). The study of 2000-2003 subprime foreclosures in Philadelphia found that the typical time for foreclosure for subprime loans was 3.6 years. Goldstein, *Lost Values*, supra note 19, at p. 54-55.

[23] Housing appreciation is the best predictor of whether a failed loan will result in a completed foreclosure or a "distress prepay" (distress refinance or sale). *See* Losing Ground, supra note 3, at 13 – 14.

[24] Information derived from conversations with Jim Rokakis, elected Cuyahoga County Treasurer.

[25] *Final Report: Predatory Lending Study Group for Attorney General Lori Swanson* (January 2007), p. 2-3, 4, *available at* http://www.ag.state.mn.us/PDF/Consumer/PredatoryMortgageLendingStudy.pdf ; e-mail from Prof. Prentiss Cox, University of Minnesota Law School, April 26, 2007 (1Q 2007 data)

[26] At the end of 2006, 15.6% of subprime ARMs in Iowa were "seriously delinquent", and 11.3% were in foreclosure inventory. MBA National Delinquency Survey.

sheriff sale foreclosures from 2000 to 2006. There were nearly as many sheriff's sales in Polk County in the first quarter of 2007 as there were in all of 2000.[27]

- The first quarter of 2007 saw 11,000 foreclosures in California, an 800% increase over this time last year. Default notices went out to nearly 47,000 more homeowners.[28]

- In March 2007, 553 families in central Arizona lost their homes, up from 40 in March, 2006.[29]

A recent study by the Joint Economic Committee reports a 42% increase in reported foreclosures nationwide from 2005 to 2006, with 2007 on track for equal or greater levels than 2006.[30]

While the impact of foreclosures on families is obvious, they are not alone in suffering the consequences. Whole communities suffer. Concentrated high foreclosure rate areas in the Twin Cities have already caused "visible blight" and are threatening to destabilize neighborhoods.[31] Spillover effects on neighborhood and the wealth of other families are substantial. According to the Woodstock Institute, families lose 1.136% of their house value for every foreclosure that occurs within an eighth of a mile (approximately one block). Thus, a family with a $115,000 house would lose $1,306 of value for each foreclosure within an eighth of a mile: three foreclosures within that radius will cost that neighbor nearly $4,000.[32] The picture is even bleaker in lower-income neighborhoods: the number of conventional foreclosures within that radius in lower-income tract is five times greater than the number in upper income tracts.[33] Ultimately, all communities,

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[27] Data supplied by Iowa Attorney General's office. There were 364 sheriff's sales in 2000, and 1222 in 2006, 346 in 1Q 07.

[28] David Streitfield, *Foreclosure pace nears decade high*, Los Angeles Times, April 17, 2007.

[29] Catherine Reagor, *Foreclosures rocket in Valley*, The Arizona Republic, April 19, 2007.

[30] *Sheltering Neighborhoods from the Subprime Foreclosure Storm*, U.S. Congress Joint Economic Committee, (April, 2007), *available at http://jec.senate.gov/Documents/Reports/subprime11apr2007.pdf*

[31] Minnesota Predatory Lending Report, *supra* n. 25, at 5; Jackie Crosby, *et al Twin Cities Troubled by Multiplying Foreclosures*, Star Tribune (November 25, 2006).

[32] Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," p. 57, 66, 69, 72, 75 *Housing Policy Debate* (17:1) Fannie Mae Foundation (2006), available at:
http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_immergluck.pdf.
(The study notes nearly 3 foreclosures within that radius for moderate income census tracts, where the average sales price is $113,000, Table 1, p. 66.)

[33] *Id* at 65, Table 1.

whether lower-income or middle-income, feel the impact in education, neighborhood stability, and even crime levels.[34]

The industry itself has begun to feel the consequences, with the housing market cooling, interest rates rising, and payment-shocked borrowers unable to avoid foreclosure. At least seven of the top 10 subprime originators in 2006, with a combined 54% of the market share last year, have been significantly affected: HSBC put $10.5 billion in reserve against losses; New Century, Ownit and Resmae filed for bankruptcy, Fremont was issued a cease and desist order by the FDIC; Option One has been sold in principle and Ameriquest has reached tentative agreements to sell it wholesale and servicing units; First Franklin was sold, and there are major layoffs at WMC, Countrywide and Wells Fargo.[35]

It is not yet clear how much damage the subprime meltdown might cause in the wider economy.[36] What is clear, however, is that a failure to remember the fundamentals of lending is dangerous for all.

Some have argued that unemployment rates explain the crisis.[37] That explanation does not withstand scrutiny. For example, Iowa continues to rank fourth nationally for subprime foreclosures, while it has the 12th <u>lowest</u> unemployment rate.[38] Similarly, the Minnesota Predatory Lending Task Force report charts the divergent tracks of foreclosures and unemployment for Hennepin County. The unemployment rate declined from 2003 to under 4% in 2006, while the foreclosure sales tripled.[39] California, too, has a low unemployment rate and a "generally healthy economy," leading observers to note

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[34] See, e.g. Noelle Knox, *Rising foreclosures reshaping communities: Subprime meltdown can hurt even those without loan problems,* USA Today, April 12, 2007; Immergluk and Smith, *supra* note 32 at 58-60.

[35] *See* Inside B&C Lending, *Option One, ResCap Face Subprime Hurdles* (May 4, 2007) at 1; *See also* Inside B&C Lending, *Citi Bails Out Ameriquest, Could Acquire Wholesale Unit* (March 9, 2007) at 2. American Bankers issues a "Subprime Status Report" to report on the rapid developments within the subprime industry as does a web site irreverently called "The Mortgage Lender Implode-O-Meter,"*at* http://ml-implode.com/

[36] See, e.g. Stephen S. Roach, *The Great Unraveling*, Morgan Stanley Global Economic Forum (March 16, 2007), http://www.morganstanley.com/views/gef/archive/2007/20070316-Fri.html

[37] *See, e.g.* Mortgage Bankers Assoc., *Suitability: Don't Turn Back the Clock on Fair Lending and Homeownership Gains,* MBA Policy Paper Series 2007-1, at 24, http://www.cmla.com/Suitability.pdf**.**

[38] CNN Money, *Unemployment State by State,* http://money.cnn.com/pf/features/lists/state_unemployment/index.html (last visited April 26, 2007). In contrast, Iowa's change in the housing price index over the past 5 years was just about half the national average (23.6%, compared to national average of 55.2%).OFHEO House Price Index: State, *http://www.ofheo.gov/HPIState.asp?FormMode=Summary* Iowa's high subprime foreclosure ranking is less surprising viewed in light of the link between foreclosures and HP , *supra* note 23.

[39] Task Force Report, n.25 *supra*, at 4. *See also* CNN Money, Unemployment State by State, supra, (Minnesota unemployment rate below national average.), http://money.cnn.com/pf/features/lists/state_unemployment/index.html

that this foreclosure crisis is unprecedented: "Traditionally, people lose their jobs, and then they lose their houses….This time, the foreclosures are happening first – and fast."[40]

IV. The betrayal of subprime's promise: losses from irresponsible lending are projected to offset homeownership gains.

The foreclosure crisis threatens to undermine – and even reverse – the much vaunted gains in American homeownership, as subprime foreclosures are on track to generate a loss of homeownership from 1998 through 2006 that *exceeds* homeownership gains over the same period. A net loss is projected for each origination year, with the net loss set to approach one million.

Table 2: Net Impact on Homeownership from Subprime Lending[41]

	Estimated Subprime Loans to First-Time Homebuyers (Homeownership Gain)	Projected Subprime Foreclosures (Homeownership Loss)	Net Homeownership Gain or (Loss)
1998	73,253	94,750	(21,497)
1999	89,309	144,567	(55,258)
2000	87,651	133,126	(45,475)
2001	80,856	105,464	(24,608)
2002	85,883	102,252	(16,369)
2003	120,807	181,464	(60,657)
2004	219,180	348,345	(129,165)
2005	324,361	632,302	(307,941)
2006	354,172	624,631	(270,459)
TOTAL 98-06	**1,435,472**	**2,366,901**	**(931,429)**

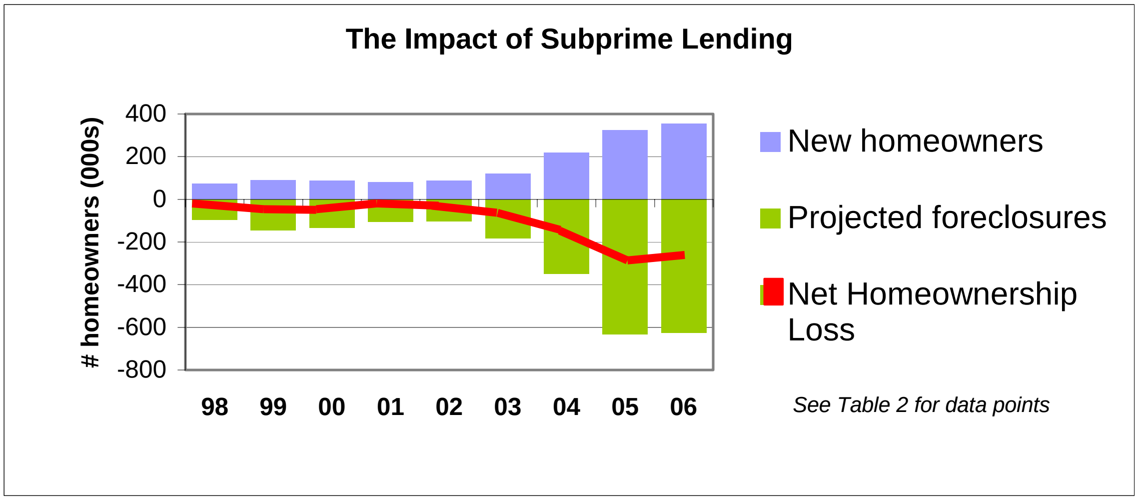
These data are illustrated graphically in the chart below:

[40] David Streitfeld, *Foreclosure pace nears decade high,* LA Times (April 17, 2007).

[41] Until the recent boom in housing prices, the great majority of subprime loans were refinances. Even in 2006, subprime refinance loans still accounted for more than half (56 percent) of all subprime loans made. (These percentages were derived from a proprietary database for 1998-2004, and from SMR Research Corp and Inside Mortgage Finance for 2005-2006. The specific percentages by year are shown below. Totals may not add to 100% because a small percentage of loans in the database are listed as "other purpose.")

	1998	1999	2000	2001	2002	2003	2004	2005	2006
% Subprime 'Refinance	67.2	66.9	60.4	64.8	67.1	67.9	60.5	60.0	56.0
% Subprime Purchase	30.5	31.6	38.5	35.2	32.8	32.1	39.5	40.0	44.0

We assumed – generously – that 25% of purchase money loans each year went to first time homebuyers. In doing so, we adopted the figure that Douglas Duncan, testifying for the Mortgage Bankers' Association, estimated for the first half of 2006. (Hearing, U.S. Senate Committee on Banking, Housing and Urban Affairs, February 27, 2007;. Testimony of Douglas Duncan, p. 5, http://banking.senate.gov/_files/duncan.pdf.)



It is this picture of problem products and practices, and the now all-too-visible consequences, that informs our comments to the proposal at hand.

V. Responses to Specific Agency Questions.

The agencies asked for comments on four specific questions. These are addressed below:

A. *The proposed qualification standards are likely to result in fewer borrowers qualifying for the type of subprime loans addressed in this Statement, with no guarantee that such borrowers will qualify for alternative loans in the same amount. Do such loans always present inappropriate risks to lenders or borrowers that should be discouraged, or alternatively, when and under what circumstances are they appropriate?*

Loans that are virtually certain to become unaffordable within two or three years can rarely be deemed appropriate. At core, the proposed Statement simply requires common sense underwriting. One would not normally have thought it necessary to say that it is prudent to refrain from making a loan that cannot be repaid.

This question poses false choices. It appears to assume that the more stable, sustainable fixed-rate product standard in the prime market is widely unavailable or unsuitable to borrowers of the more dangerous loans here addressed. Yet that is not borne out by the facts. Further, it assumes that loans must be available "in the same amount" as they would be with hybrid ARMs. Yet that, too, may be an unwarranted concern, given the market's past tendency to encouraging borrowing larger amounts than needed.

One of the many tragedies about the recent subprime crisis is the fact that the exploding ARMs often had higher interest rates than sustainable loans for which the borrowers could qualify. As noted earlier, 20% of subprime borrowers could have qualified for a conventional fixed-rate loan, likely at 6% to 7%.[42] The industry itself has acknowledged

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[42] *See* note 10, *supra*.

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.[43]

In addition to being steered away from the less risky, equally affordable fixed rate mortgages (FRMs) to ARMs, many of the borrowers were further penalized by being given loans with other features that added both cost and risk. Roughly half of borrowers needlessly paid on the order of up to 85 basis points more to receive a stated income loan, when the vast majority had W-2's that would allow them to document their income and save this increase in the interest rate.[44] And subprime borrowers who received loans from mortgage brokers (approximately 71%[45]) generally paid yield-spread premiums, which often increased their interest rates by 50 to 100 basis points or even more.[46]

Compounding the added costs from yield spread premiums is the fact that they are tied to prepayment penalties. Because many lenders limit the yield-spread premiums if there is no prepayment penalty, brokers put borrowers into loans with those penalties to maximize their own compensation.[47]

If the proposed Statement has the impact of steering originators away from these unnecessary, and even counterproductive, higher-priced products, then it will have simply restored rationality to what has been a highly imperfect market.

Similarly, if the result of sound underwriting is that loan principal amounts will not be needlessly "upsold", that, too, will be positive. It has long been understood that "push marketing" has been a staple force in this market, and that one of the major hooks to push a subprime refinance loan was to encourage debt consolidation or cash-out refinancing.[48] If prudent underwriting means that originators do not push more home-secured debt than the homeowners really need and desired, that, too, is a positive outcome.

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[43] 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.

[44] *See Appx. B.*

[45] 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.

[46] *See* Appendix B (showing an average premium of 64 basis points for each yield-spread point).

[47] Lenders often limit the YSP if the loan does not have a prepayment penalty, *see, e.g.* Appx. B.

[48] See, e.g. Goldstein, *Lost Value, supra* note 19 at 19.

The possibility that these type of loans "in the same amount" may not be available in the purchase money context also provides no ground for failing to require sound underwriting. Indeed, marketing these short-term ARMs and the non-traditional products as "affordability products" has been a misnomer. Making unsustainable loans to purchase unaffordable homes is not a recipe for success for anyone.[49] Refuting the claim that "inhibiting the subprime market denies low- and moderate-income people the American Dream," North Carolina Banking Commissioner Joseph Smith stated, "The American Dream is life, liberty, and the pursuit of happiness. Temporary shelter in a house you cannot afford is not happiness; it is a delusion."[50]

In assessing whether the hybrid ARMs at which this Statement is aimed may sometimes be appropriate, we note first that these standards do not prohibit them: they simply remind lenders of basic, prudent underwriting principles that used to be the norm for the lending business. Indeed, as we note elsewhere, they are already embodied in existing agency pronouncements.[51]

In any event, the purported value of these products must be weighed against the costs they entail. 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 consistently extremely short – recent cash flow assumptions from Fitch Ratings carry an assumed average loan life of two and one-

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[49] As one homeowner who purchased a home in North Carolina with a 2/28 ARM, unaware of the payment shock she would face, put it, "Nobody buys a home to have to sell it two years later. That's heartbreaking." She noted that she wouldn't have had to buy a home when she did – she could have, and would have waited – if she'd understood what she faced with that mortgage.

Indeed, the widespread availability of poorly underwritten, unsustainable mortgages arguably *interfered* with normal market forces as to housing prices in some regions. For example, in 2005, the median home price in California was approximately $525,000. The income needed to sustain a mortgage at that price was about $129,000, yet the median income in California then was only half that -- $60,000, for a shockingly low "affordability index" of 14%. With that kind of a disconnect between incomes and home prices, it is housing affordability that is the problem, not the availability of credit. *See, e.g.* CAR Reports December Housing Affordability Index at 14% (Press release, February 9, 2006), (http://www.car.org/index.php?id=MzU5Mjg=) . (Median housing prices and income vary slightly depending on sources and specific reference date used.)

[50] *See* Joe Smith, "*Viewpoint: Mortgage Market Needs New Type of Regulation*" (March 16, 2007), American Banker,

[51] *See* Section VI-B, below.

half years for the most common variety of subprime ARM loans.[52] 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 to get a hybrid ARM versus a fixed rate mortgage, 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.

There has already been a real cost to families, communities, and the industry of being overly solicitous of dangerous products. The rare circumstance where no equally appropriate alternative is available is not sufficient to warrant cutting back on these sound proposed principles.

B. *Will the proposed Statement unduly restrict the ability of existing subprime borrowers to refinance their loans and avoid payment shock? The Agencies are also specifically interested in the availability of mortgages that would not present the risk of payment shock?*

Sound underwriting does not "unduly restrict" credit; rather it safeguards homeownership. Given the fact that the guidelines in this Statement are simply common sense underwriting, it is difficult to see how they could interfere with any genuinely *helpful* refinancing.

In Section V-A, we noted that FRMs, without additional unnecessary features that add to the loan's cost not only are a sound, sustainable alternative, but also that there is little explanation other than market failure for the relative absence of such loans in the subprime market over the past few years.[53]

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[52] Fitch Ratings, *U.S. RMBS Intex-based Cash Flow Model* (last verified Feb. 7, 2007).
[53] See note 16 for an example of the perverse market incentives.

While we recognize that the difference between fixed rates and ARMs is not always this slight,[54] it is also the case that had common sense underwriting standards been in place the past two to three years, far more borrowers would undoubtedly have had the more suitable and sustainable fixed-rate loans. In turn, far fewer borrowers would be facing payment shock and the potential loss of their homes.

In addition to looking more readily to the steady 30-year FRM product for an alternative, less hazardous versions of the alternative products are being developed. For instance, Freddie Mac recently announced that it is "developing fixed-rate and hybrid ARM products that will provide lenders with more choices to offer subprime borrowers. For example, in contrast to the payment structures of many of today's '2/28' ARMs, Freddie Mac's new hybrid ARMs will limit payment shock by offering reduced adjustable rate margins; longer fixed-rate terms; and longer reset periods."[55]

Looking to "more of the same" as the solution to offer refinancing to borrowers facing payment shock runs the risk of merely delaying the problem, or perhaps even making it worse. We cannot be sure that another generation of the same kinds of loans will have a better outcome the next time, but looking at the question of "serial" refinancings may provide some hints.

Research on serial refinances is resource intensive, hence rare. But what has been done indicates, first, that subprime borrowers are likely to refinance into another subprime loan rather than a prime loan, and, second, that serial refinancings are, in fact, likely to increase the risk of loss to foreclosure. The experience, then, is that subprime loans are not "credit repair" products (as they are referred to in the agencies' request for comment, *cf.* 72 Fed. Reg. at 10536), or the promised "bridge to prime." For example, we reviewed 106 2/28 hybrid ARMs written in Mecklenberg County, North Carolina, by Option One in the first three quarters of 2004. Of those loans from that pool that had refinanced by February, 2007, three in four refinanced into yet another subprime loan. Only one in four refinanced into a prime loan.[56] Similarly, the Philadelphia study found that two-thirds of subprime loans refinanced into other subprime loans.[57]

The serial subprime refinancing that is so common, in turn, compounds the homeowners' exposure to foreclosure risk. CRL estimated a cumulative foreclosure rate of 34 to 36% for the second and third refinance in the series.[58]

[54] The current differential remains relatively slight currently. *See Appdx. B.*
[55] http://www.freddiemac.com/news/archives/corporate/2007/20070227_subprimelending.html.

[56] "Case Study in Subpprime Hybrid ARMs Refinance Outcomes," (February 21, 2007), Center for Responsible Lending, available at: http://www.responsiblelending.org/pdfs/subprime-outcomes-_2_.pdf .

[57] Goldstein, *Lost Value*, supra note 19, at Appx B, p. 74.

[58] *Losing Ground*, note , above, p. 18. *See also*, Goldstein, *Lost Value*, *supra* note 19, at 60 – 61, 66 (discussing relationship of rapid refinancing and foreclosures.)

In light of the very real danger that inappropriate refinancing may exacerbate, rather than ameliorate, the ultimate risk of loss of the home, we believe that sound underwriting standards will not "unduly" restrict positive refinancing options. Instead, it should help protect against more harmful loan churning and further equity stripping.

To the extent that the implicit assumption in the question is that refinancing is the preferred avenue for avoiding payment shocks as the rates reset, we believe that may not be the case. We are highly doubtful that replacing one round of problem 2/28s with a second round of them is an effective solution. We note elsewhere that refinancing may be less suitable in many cases than modifying the existing loans, such as by converting them to fixed rate loans, for example, *see* Section VII, below.

C. *Should the principles of this proposed Statement be applied beyond the subprime ARM market?*

We recognize that the most significant problems are concentrated in the subprime arena, and therefore it is most important that they be applied and enforced in this market. Nevertheless, the guidelines embodied in the Statement are nothing more than what genuinely responsible lenders never stopped doing. These concepts are lending business fundamentals -- for any segment of the market. It is also the case that the definition of "subprime" is fluid and great care should be taken to ensure that consumers are afforded appropriate protection against dangerous products and practices, regardless of any amorphous definitions of products or borrowers.[59]

Recent data indicates that the Alt-A market may be beginning to show signs of weakened underwriting, as signs of deterioration in quality are beginning to show. This is a market segment that should be monitored closely. Though January 2007 delinquency figures were low when compared to subprime, they still were double that of a year earlier.[60]

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[59] The proposed Statement refers to the definition found in the 2001 Interagency Expanded Guidance for Subprime Lending Programs. That definition says that it "may include" one or more of the following: FICO score of 660, and DTI of 50% or more "or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income." (p. 3). In the six years since that definition, it appears as though the market has shifted, with FICO scores of between 620 and 700 now being considered generally "alt-A", instead of subprime. Mortgages are categorized as Alt A when they fall just short of the typical standards of Fannie Mae and Freddie Mac, the two largest U.S. mortgage companies. Some mortgage lenders require a credit score of at least 700 for an Alt A mortgage, while others will accept a score as low as 620. The maximum score is 850. The average credit score is in the 600s, according to Bankrate.com. *See* http://www.bloomberg.com/apps/news?pid=20601103&sid=a8ilcv.eOxMc&ref=patrick.net; *See also Top Subprime Market Players & Key Subprime Data 2006* , at 15, Inside Mortgage Finance (2006) (subprime lenders report that Alt-A players have been "picking off... their traditional 'sweet spot,' the mid-600 FICO range.)

[60] *Alt-A Mortgage Market Showing Weakness: Weakness Spreads From Subprime Mortgage Market to So-Called Alt-A Segment*, Associated Press, April 10, 2007.

Further, while most attention has been focused on the "exploding ARM" type of 2/28, with initial teaser rates, it is also the case that equally poor underwriting – or even fraudulent underwriting – has been used with fixed-rate subprime loans and the premium rate ARMs, where the initial rate is in fact higher than the index plus the contract margin. There is little reason for these basic principles not to apply in these cases, as well.

D. *We seek comment on the practice of institutions that limit prepayment penalties to the initial fixed rate period. Additionally, we seek comment on how this practice, if adopted, would assist consumers and impact institutions, by providing borrowers with a timely opportunity to determine appropriate ratios relating to their mortgages. We also seek comment on whether an institutions' limiting of the expiration of prepayment penalties such that they occur within the final 90 days of the fixed rate period is a practice that would help meet borrower needs?*

In assessing any policies on prepayment penalties, it is critical to note that, whatever the value of prepayment penalties to prime borrowers may be, the purported trade-offs in the subprime market, as represented on the rate sheets, are overstated. We have found that prepayment penalties resulted in no statistically differences in interest rates, and that for purchase money loans, they resulted in higher rates, most likely as a result of the perverse link between prepayment penalties and yield spread premiums.[61] Estimates are that only about 18% of the "value" of the prepayment penalties (as a trade-off for a rate discount) actually benefits the borrowers, and each $1 in rate benefit is offset by $2 in penalty fees.[62]

Lenders claim that prepayment penalties are not relevant for borrowers with hybrid ARMs because the penalties typically remain in effect only as long as the teaser rate period. [63] But since most borrowers cannot afford the monthly payment once the rate resets, they have to either refinance prior to reset (and incur prepayment fees) or potentially default on the post-reset payments, which gives them little opportunity to refinance on favorable terms (in addition to damaging their credit, and incurring further equity-stripping penalties).

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[61] A CRL study has found that interest rates on refinance loans with the penalties were not different than the rates on loans without the penalties. For borrowers purchasing homes, interest rates actually were higher. In 2002, subprime borrowers who had a 30-year, fixed-rate mortgage paid an average of 40 basis points more if their loan included a prepayment penalty than if it did not. Keith S. Ernst, *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages* 1 (Jan. 2005), available at http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf. *See also* text accompanying note 14, *supra* and Appx. B on the link between prepayment penalties and YSPs.

[62] Michael D. Calhoun, "Are Legislative Remedies to Limit Predatory Lending Really Remedies?", at 5, (March 14, 2007), *Financing Community Development: Learning From the Past, Looking to the Future,* Discussion paper, Federal Reserve System's 5th Community Affairs Research Conference, Wash. D.C. March 29-30, 2007.

[63] Kurt P. Pfotenhauer of the MBA stated recently that most borrowers refinance their loans before the rate adjusts. Vikas Bajaj, "Freddie Mac Tightens Standards", The New York Times (Feb. 28, 2007)).

Last, but certainly not least, we note that prepayment penalties increase the risk of foreclosure.[64] Given the cloudy benefits of prepayment penalties, weighed against clear costs, there is no reason to encourage prepayment penalties at all, much less ones that force borrowers into a narrow window of time in which they can seek to refinance to avoid payment shock. Particularly in a time when interest rates are rising, or threaten to rise, prudence dictates that refinancing opportunities be sought by families as soon as possible. In addition, if borrowers with credit blemishes are successful in cleaning up their credit, they should refinance into a more affordable loan as quickly as possible, to help reduce the chances of facing recurring credit or income problems. Therefore, CRL believes that prepayment penalties should be eliminated for subprime loans entirely. Limiting the prepayment penalty to six months in advance of the first reset is the most minimal of protections, [65] but would allow time to search for a suitable loan in anticipation of rate reset, and the flexibility to act as early as possible in a rising rate environment.

VI. Comments on the proposed Statement.

We strongly support and appreciate the agencies' important work in the Statement. We do believe, however, that they can be further clarified, and, in some instances, strengthened, in order for the Statement to have its desired impact.

We address each set of considerations proposed.

A. Predatory lending considerations.

The reminder of predatory lending indicia is welcome. The dangers of these practices, as has become all too evident, do not lie merely in the possibility of violating Section 5 of the FTC Act, but of writing loans that default, and increase the likelihood of foreclosure. For that reason, if no other, there should be no reasonable objection to these principles.

We note, however, that the first cited element – lending based on liquidation value of the collateral rather than ability to pay -- was articulated in the 2001 Expanded Subprime Guidance.[66] Despite this long-standing regulatory position, asset-based lending apparently became common in regions where property values appreciated rapidly in recent years. The hybrid ARMs and the non-traditional loans were sold to borrowers with the assurance that by the time that rates or payments reset, the property would have appreciated and the loan could be refinanced. Yet without adequate attention to the

[64] *See* Table 1 and note 14, *supra*.

[65] New York limits the duration of prepayment penalties to one year, with no apparent adverse impact on the availability of credit. *See, e.g.* Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending (February 23, 2006), available at: http://www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf.

[66] 2001 Interagency Expanded Guidance for Subprime Lending Programs, p. 9 (agencies will generally classify lending overly dependent on collateral pledged as substandard.)

ability to pay from current and expected income in the first place, that was a false assurance. Even if the property did appreciate during the interim, the impact of a somewhat lower loan-to-value payment obligation was unlikely to be sufficient to turn an unaffordable loan into an affordable one, especially in a rising interest rate environment. The experience in these regions stands as a reminder of the need for adequate oversight and enforcement of guidelines.

Characterizing "asset-based lending" as a predatory practice, however, fails to account for a reverse problem that surfaced in the regions with stagnant or slow property appreciation. In those areas, the pressure to generate originations led to a too-common practice of making mortgages that placed the homeowner underwater at the outset. This practice was aided by the use of inflated appraisals arranged or encouraged by the loan originators. (As the states' action against Ameriquest demonstrates, this problem was not limited to broker-originated loans.[67]) This feature prevents homeowners from being able to refinance to beneficial loans, irrespective of their payment history, thus trapping them in the higher cost loan. We urge the regulators to recall that placing borrowers "under water," unbeknownst to them, is also a predatory lending practice.

Because the borrower's home is jeopardized irrespective of whether lender is over-secured or under-secured by the collateral, we also recommend that making a loan without due consideration of a borrower's ability to repay the mortgage according to its terms be considered an independent indicator of predatory lending.[68]

B. *Underwriting standards.*

In view of the widespread understanding that weakened underwriting has been a significant contributor to the existing problems in the subprime market, all reminders that underwriting is integral and fundamental to the lending business are welcome.

<u>Ability to repay</u>:[69] We welcome the reminder in this Statement that "prudent qualifying standards recognize the potential effect of payment shock," and that underwriting

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[67] *See, e.g.* State of Iowa v. Ameriquest Mortgage Co, et al, Eq. # EQCE-53090, filed March 21, 2006, Para. 16(E). http://www.state.ia.us/government/ag/images/pdfs/Ameriquest_Pet.pdf. (Ameriquest denied the allegations, see Consent Judgment, Para. II-B, filed March 21, 2006.) http://www.state.ia.us/government/ag/images/pdfs/Ameriquest_CJ.pdf. *See also* Goldstein, *Lost Values,* supra note 19, pp. 58 – 59 (noting pressure on appraisers, and citing overvaluation as a "stronger explanation than declines in home prices for the presence of so many loans" with principal amounts exceeding home values.)

[68] We note that the 2001 Expanded Guidance warned institutions that "loans to borrowers that do not have the capacity to service their loans generally will be classified substandard." 2001 Expanded Guidance, at p. 9.

[69] Existing guidelines already provide that "prudently underwritten real estate loans should reflect all relevant credit factors, including "the capacity of the borrower, or income from the underlying property, to adequately service the debt." (*See* Interagency Guidelines for Real Estate Lending, at, e.g. 12 C.F.R. 34 Part D, Appendix A.) Together with the guidance against "asset-based lending" as a predatory or abusive

analysis "should" include an ability to pay based on a fully-amortizing, fully-indexed rate. Not all hybrid ARMs, however, have teaser rates. Some are premium rates, and even non-teaser loans will create payment shock if, as has been the case in recent years, ARMs continue to be push-marketed in a rising rate environment. To address the former, it would be appropriate to caution that ability to pay should be evaluated against the greater of the initial rate or the fully indexed rate. To the extent that this statement is hortatory, at the least, a reminder is warranted to the effect that underwriting to a very high debt-to-income ratio with an ARM, without regard to residual income, is likely create hardships for both borrower and lender in a rising rate environment.[70]

Risk-layering and verification of ability to repay: We generally concur with the proposed Statement's caution that debt-to-income (DTI) assessment is "particularly important if the institution relies upon reduced documentation or allows other forms of risk layering." However, any DTI assessment is virtually meaningless if income is not verified. The Statement should require originators to verify income using W-2, tax return, bank account statement or other reasonable third party verification. Perhaps borrowers who can prove that they are self-employed could receive low-documentation loans.

The Statement says that for "higher risk loans" stated income and reduced documentation should be accepted only if there are mitigating factors that clearly minimize the need for verification of repayment capacity. The misuse and improper risk-layering of stated income and reduced documentation is a chronic problem in the subprime market. We urge that this important restriction be applied to all subprime loans.

Higher cost does not mitigate risk of failed loans**:** We particularly welcome the reminder that higher prices are not a mitigating factor when it comes to minimizing the risk of foreclosure. As the agencies are aware, higher interest rates only serve to increase the difficulty that families have in making payments, and therefore increase the risk of default.

C. Consumer protection principles.

Ability to repay: This is as central to protecting consumers as it is to protecting the safety and soundness of the institution, and it is appropriate that the statement serve as a reminder of that fact.

Sales information & disclosures: Push-marketing of loans themselves, and of certain expensive, dangerous products and terms, have been a staple in the subprime market from its earliest days. While we welcome the caution in this statement about providing "clear and balanced" information about the relative benefits and risks, we are doubtful that it is

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practice, both lenders and regulators arguably had sufficient basis to have addressed these problems already.

[70] The 2001 Interagency Expanded Guidance for Subprime Lending Programs includes as one indicator of a "subprime borrower" a 50% or greater debt-to-income ratio, "or otherwise limited ability to cover family expenses after deducting total monthly debt-service requirements from monthly income." p. 3.

sufficient to reverse the lending culture that has developed over the past decade. Apart from that the complexities and the need for a grasp of arcane knowledge (such as the direction of LIBOR), there are limits to what disclosure can be expected to accomplish.[71]

For the same reasons, we fear that disclosure of a pricing premium for a reduced documentation product is unlikely to serve its intended function. Experience with sales of other features where price premiums allegedly purchase an offsetting benefit does not augur well for using a disclosure approach to curbing the market's appetite for higher-priced products. *See note 73* below.

As proposed in the Statement, consumers should be informed of "how the new payment will be calculated when the introductory fixed rate expires" and "how any prepayment penalty will be calculated." We are currently seeing the inadequacy of disclosures of potential payment shock when these loans are sold in a rising rate environment.[72] As for the disclosure of how a prepayment penalty will be calculated, we have seen such disclosures, and we have seen how ineffective they are, since an explanation of calculation methods never conveys information meaningful to the average consumer.[73]

As noted elsewhere, CRL recommends that prepayment penalties be barred in subprime loans, and that tax and insurance escrows be required. *See Sec. V, supra.* If these recommendations are adopted, of course, the issue of disclosures about these items would be moot.

D. Control systems.

<u>Perverse compensation incentives:</u> Since the dominance in the market of many of the most hazardous products is supply-driven, rather than demand-driven, we believe that reform of the incentive system, rather than disclosure, is what is necessary to lead to the desired results. We are heartened by the regulators' proposal to:

> design compensation programs that avoid providing incentives for originations inconsistent with sound underwriting and consumer protection principles, and that

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[71] *See, e.g.* Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 Harv. J. on Leg. ____ (*forthcoming* 2007), draft available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952907.

[72] *Id*.

[73] For example, as we discussed in Section V, above, there is less than meets the eye to the purported benefits of prepayment penalties in the subprime. We have seen examples of the notices of how prepayment penalties were to be calculated given already in the subprime market. The description of the calculation method was unintelligible. Even with an explanation of how it would be calculated, as the proposed Statement recommends, it failed to convey any meaningful information of either the value of the purported benefit, or the real –dollar cost of the penalty. It was for that reason, for example, that the States' injunction in the Household case specified both the rate differential for loans with and without prepayment penalties, and the maximum amount of prepayment penalty. *See, e.g.* State of Iowa v. Household International, Consent Judgment, Para. 15, (Dec. 16, 2002).

> do not steer consumers to these products to the exclusion of other products for which the consumer may qualify. 72 Fed. Reg. at 10536.

However, to be of value, the market's efforts to comply with this guidance must be the subject of continuous strict oversight and enforcement.

VII. The agencies should take a leadership role in convening stakeholders to develop broad foreclosure prevention strategies.

The proposed Statement contains much that can be useful in preventing future abuses of the sort that have contributed to today's crisis, so long as the guidelines are enforced. But that still leaves us with the loans that are already in place, and in trouble. Many within the industry have recognized that the potential loss to all stakeholders can be reduced by concentrating on loss mitigation and loan modification efforts.[74]

The agencies asked whether issuing their proposed Statement will "unduly restrict the ability of existing subprime borrowers to refinance their loans and avoid payment shock." We believe that there are alternatives other than refinancing to help borrowers avoid payment shock. As we discussed above, if a borrower could not qualify for a refinance of a troubled loan when his or her ability to pay is taken into account, then the result will be another troubled loan. It is not a solution for the borrower, and, indeed, simply subjects the lender who makes it to a risky loan. That concern about this proposed Statement is misplaced.

Further, there is the moral hazard of making refinancing dollars easily available to "bail-out" the lenders and investors who made the loans without reasonable regard to ability to pay in the first instance. Lenders who made and investors who benefited from abusive loans should not receive be paid off in full, or their behavior in the future is unlikely to change.

Ultimately, then, the most efficient, fair, and cheapest wide-scale strategy is encouraging all affected parties to assure that loan modifications are available. The servicer and investors need to recognize that they are best off by modifying the loan to a fixed-rate payment that the borrower can afford, rather than receiving cents on the dollar selling a real estate owned on a potentially depressed market. Loan modifications can be done readily even within legal constraints of the secondary market, as they are widely permissible in the event of default or "reasonable probability of default."[75] We

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[74] E.g. *The Day After Tomorrow: Payment Shock and Loan Modifications,* p. 1, 17 (Credit Suisse, April 5, 2007), noting "a dramatic philosophical shift in servicing practices from rapidly moving delinquent loans into foreclosure to keeping borrowers within the home," as it is, in many cases, the "loss minimizing alternative."

[75]*See, e.g.* Dale Westhoff, Bear Stearns & Co, Inc *Subprime Spillover* (March 9, 2007) at 15; *The Day After Tomorrow: Payment Shock and Loan Modifications,* p. 1, 17 (Credit Suisse, April 5, 2007); *See also* Jody Shenn, "Moody's May Penalize Subprime Bonds that Cap Changes," Bloomberg (April 25, 2007). (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

appreciate the agencies' recent reminder to the industry that that such actions will not be penalized and should be encouraged, and we encourage all the regulators to be actively involved in on-going efforts.

Thank you for this opportunity to comment. We strongly concur with the recommendations made in the agencies' proposed Statement, and we commend the agencies for issuing them.

Respectfully submitted,

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<u>Appendices:</u>

Appendix A: Summary of selected 2007 MBS subprime offerings
Appendix B: Rate sheet

be modified. This is welcome news, especially since Moody's rates more than 90 percent of subprime mortgage-backed securities.)

Appendix A: Summary of selected 2007 MBS subprime offerings

Morgan Stanley ABS Capital I Inc Trust 2007NC2
79.30% ARMs
41.14% Stated Income
73.29% Prepayment penalty
(Originator: New Century)

HASCO Trust 2007HE2
85.95% ARMs
36.29% Stated Income
71.56% Prepayment Penalty
(Originators: D1, WMC)

Saxon Asset Securities Trust 2007-2
70.38% ARMs
36.84% Stated Income
69.65% Prepayment Penalty

Natixis Real Estate Capital Trust 2007-HE2
86.08% ARMs
52.48% Stated Income
79.58% Prepayment Penalty
(Originators: Multiple subprime originators)

Soundview Home Loan Trust 2007-WMC1
85.97% ARMs
49.13% Stated Doc
67.59% Prepayment Penalty
(Originator: WMC)

Appendix B: Summary of selected rate sheets

Lender	Rate Increase from ARM to 30 Yr Fixed	Limit on YSP with No Prepay	Avg. Rate Premium per 1% YSP
Argent 4/20/07	0.6	Yes	0.625
BNC 4/24/07	0.4	Yes	0.625
Decision One 5/2/07	0.55	Yes	0.625
Long Beach 5/7/07	0.5	Yes	0.65
New Century 03/30/07	0.7	Yes	0.625
Option One 4/27/07	0.75	Yes	0.6
WMC 4/1/07	0.625	Yes	0.75

Argent: http://www.argentmortgage.com/am-content/ratesheets/wholesale/CA-SO_RATES.pdf

BNC: http://rates.bncmortgage.com/scoreprogram/adv_area1.pdf

Decision One: http://www.d1online.com/content/d1_rate_sheet_CA.pdf?state=CA&doc=ratesheet

Long Beach: http://longbeachmortgage.com/bfo/ratesDisplay.do?fwd=attachment&contentId=2758

New Century:
http://www.newcentury.com/ratesAndPrograms/DynamicRateSheets.pdf?comp_code=CONV/WSL&matrix=108&state=CA&zip_code=93000&tco=0&color=1&isAE=0

Option One: http://www.oomc.com/broker/rate_sheets/west_la.pdf

WMC: http://www.wmcmortgage.com/rates/rates_view.asp?rateid=140451 and http://www.wmcmortgage.com/rates/rates_view.asp?rateid=140449

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to Celebrate the Start of a New Season

Receive 50bps from a new pricing special in addition to 10-20bps from existing discounts!
Take advantage now, our rates will not be this low forever!

New Pricing Special* Details:

- Expiration Date: May 31, 2007

50bps off ARM products, AA+ Risk Grade:

Full Documentation:

- Less than or equal to 90% LTV
- 620 minimum credit score

Stated Documentation:

- Less than or equal to 90% LTV
- 640 minimum credit score

Existing Discounts:

10bps discount off Full Doc loans:

- Disposable Income greater than or equal to $2,500

10bps discount:

- Cash Reserves greater than or equal to 6 months Principle and Interest (P & I)

* Not applicable to CorOne® loans or Correspondent business channels

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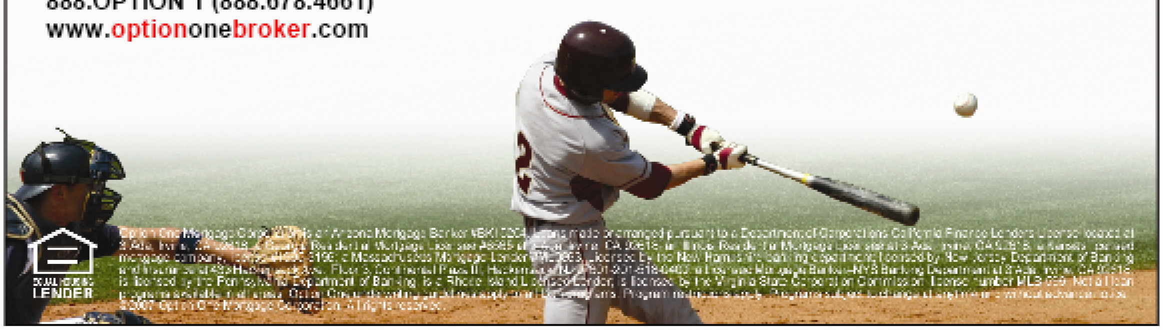

Option One Mortgage Rate Sheet — Latitude Advantage

OPTION ONE MORTGAGE

EQUAL HOUSING LENDER

West Area Rate Sheet - 2 Year Fixed - 2 Year Prepay / Par (CA, HI, WA, OR, NV, ID, MT, WY, UT, CO, AZ, AK)

GRADE	SCORE	Full Doc						Stated Income					
12-Mo Mtg.	LTV	65%	70%	75%	80%	85%	90%	65%	70%	75%	80%	85%	90%
AA+	700+	6.400	6.450	6.550	6.650	7.200	7.550	7.500	7.550	7.650	7.750	8.350	9.200
	680	6.450	6.500	6.600	6.700	7.350	7.700	7.550	7.600	7.700	7.800	8.500	9.350
0X30	660	6.500	6.550	6.650	6.750	7.400	7.750	7.600	7.650	7.750	7.950	8.750	9.500
dotted box = I/O min	640	6.650	6.700	6.800	6.900	7.700	8.100	7.750	7.800	8.000	8.200	8.900	9.700
Margin = 6.00	620	6.750	6.800	6.900	7.000	7.800	8.200	7.850	8.000	8.100	8.300	9.100	9.900
	600	6.950	7.000	7.100	7.400	7.950	8.400	7.950	8.100	8.200	8.450	9.250	10.200
Stated Wage Earner:	580	7.300	7.350	7.650	7.800	8.400	8.900	8.400	8.450	8.600	8.950		
Max 80% min 560 score	560	7.500	7.650	7.850	8.100	8.750	9.300	8.700	8.850	8.900	9.350		
Max 85% min 600 score	540	7.850	8.100	8.300	8.550	9.300							
Max 90% min 620 score													
AA	700+	6.750	6.800	6.900	7.000	7.450	7.800	7.800	7.850	7.950	8.050	8.700	9.450
	680	6.800	6.850	6.950	7.050	7.700	7.950	7.850	7.900	8.000	8.100	8.850	9.600
1X30	660	6.850	6.900	7.000	7.100	7.650	8.000	7.900	7.950	8.050	8.150	9.000	9.750
dotted box = I/O min	640	7.000	7.050	7.150	7.250	7.800	8.200	8.050	8.100	8.300	8.400	9.150	9.950
Margin = 6.20	620	7.100	7.150	7.250	7.350	7.900	8.300	8.150	8.300	8.400	8.500	9.350	10.150
	600	7.200	7.250	7.350	7.500	8.050	8.500	8.350	8.500	8.600	8.750	9.600	10.450
Stated Wage Earner:	580	7.550	7.600	7.750	7.900	8.500	9.000	8.700	8.750	9.000	9.250		
Max 80% min 560 score	560	7.750	7.900	7.950	8.200	8.850	9.400	9.000	9.150	9.200	9.550		
Max 85% min 600 score	540	8.100	8.350	8.400	8.650	9.400							
Max 90% min 620 score													
A	700+	6.850	6.900	7.000	7.100	7.550	7.900	7.900	7.950	8.050	8.150	8.800	9.650
	680	6.900	6.950	7.050	7.150	7.800	8.050	7.950	8.000	8.100	8.200	8.950	9.800
2X30	660	6.950	7.000	7.100	7.200	7.750	8.100	8.000	8.050	8.150	8.250	9.100	9.850
	640	7.100	7.150	7.250	7.350	7.900	8.300	8.200	8.250	8.350	8.450	9.300	10.100
Margin = 6.40	620	7.200	7.250	7.350	7.450	8.000	8.400	8.350	8.400	8.500	8.700	9.450	10.250
	600	7.300	7.350	7.450	7.600	8.150	8.600	8.550	8.700	8.700	8.850	9.700	10.550
Stated Wage Earner:	580	7.650	7.700	7.850	8.000	8.600	9.100	9.000	9.050	9.200	9.350		
Max 80% min 560 score	560	7.850	8.000	8.050	8.300	8.950	9.500	9.200	9.350	9.350	9.700		
Max 85% min 600 score	540	8.200	8.450	8.500	8.750								
Max 90% min 620 score													
B	700+	7.250	7.350	7.500	7.650	8.100	8.450	8.300	8.400	8.550	8.700	9.350	10.200
	680	7.400	7.500	7.650	7.800	8.600	8.900	8.400	8.500	8.650	8.800	9.700	10.600
4X30	660	7.450	7.550	7.750	7.850	8.750	9.200	8.600	8.700	8.950	9.050	10.250	11.100
or	640	7.650	7.750	7.950	8.000	9.050	9.550	8.800	8.900	9.100	9.150	10.500	11.400
2X30,1X60	620	7.800	7.950	8.150	8.200	9.450	9.950	8.950	9.100	9.300	9.400	10.900	11.800
	600	7.950	8.050	8.200	8.250	9.650	10.200	9.200	9.400	9.350	9.500	11.200	
Margin = 6.65	580	8.350	8.400	8.650	8.750	10.250	10.800	9.700	9.750	10.000	10.100		
	560	8.600	8.700	8.850	9.100			10.000	10.050	10.150	10.500		
	540	8.950	9.100	9.350	9.600								
C	700+	7.600	7.700	7.850	8.000	8.450	8.850	8.650	8.750	8.900	9.050	9.700	10.600
	680	7.700	7.800	7.950	8.100	8.900	9.300	8.750	8.850	9.000	9.150	10.050	11.050
6X30,1X60,1X90	660	7.800	7.900	8.100	8.250	9.100	9.700	8.800	8.900	8.950	9.100	10.250	11.250
or	640	8.000	8.100	8.300	8.350	9.400	10.100	9.050	9.250	9.450	9.500	10.850	11.950
6X30,2X60,0x90	620	8.150	8.300	8.500	8.550	9.800	10.550	9.200	9.300	9.500	9.650	11.100	12.250
	600	8.300	8.400	8.550	8.650	10.000	10.850	9.550	9.750	9.800	9.900	11.550	
Margin = 7.25	580	8.800	8.850	9.100	9.250	10.700		10.200	10.250	10.500	10.650		
	560	8.950	9.000	9.200	9.500			10.350	10.400	10.500	10.900		
	540	9.300	9.450	9.700									
CC	700+	9.650						10.850					
	680	9.650						10.850					
MTG = OTHER	660	9.750						11.050					
	640	9.950						11.250					
Margin = 7.40	620	10.050						11.600					
	600	10.250						11.850					
	580	10.600						12.400					
	560	11.050						12.800					
	540	12.000											

Minimum Rates

2/28 and 3/27 @ 5.60, 5/25 @ 5.99, Fixed (15,20,30) @ 6.40

Pricing Adjustments

Loan Size (Max 1 YSP >$650,00+)	Rate Adj
$750,000 +	0.250
$200,000 - $749,999	- -
$175,000 - $199,999	0.250
$150,000 - $174,999	0.500
$125,000 - $149,999	0.750
$100,000 - $124,999	1.250
$75,000 - $99,999	2.000
$50,000 - $74,999	3.000
<$50,000 (Applies to 2nd TD only)	2.000

Products	Rate Adj
Fixed (Jumbo Loans)	0.750
Fixed (Fannie Mae Conforming Limits)	0.500
3-year ARM	0.250
5-year ARM	0.350
40-Year or 50-Year (Term Extension - min 540)	0.100
Interest-Only >= 620 (AA+, AA only)	0.250
Interest-Only < 620 (AA+, AA only)	0.400

Documentation	Rate Adj
Business Bank Statements (add-on to Full Doc)	0.250
No-Doc (Add-on to Stated Rate, AA+ only)	0.600
Score Advantage: Qualify with Co-Borrower Score	0.500
Stated Wage Earner **(add to Stated: CA & HI @ .10)**	0.250

Other Adjustments	Rate Adj
Purchase	(0.100)
Disposable Income >= $2,500 (Full Doc Only)	(0.100)
Cash Reserves >= 6 Months Principal & Interest	(0.100)
First Time Home Buyer (FTHB)	0.250
Manual Submission (Paper Submission)	0.400
12 Months Verification of Rent (FTHB only)	(0.100)

Buyups/Buydowns	Points		Rate Adj
2-year Fixed	1.000	=	0.600
3-Year Fixed	1.000	=	0.550
5-Year Fixed	1.000	=	0.550
Fixed	1.000	=	0.550

Prepay Charge/Buyout (2/28 = 2yrs, 3/27, 5/25 & fixed = 3yrs) Max 1 YSP where PP Prohibited (State Specific)	Points		Rate Adj
Partial Prepay State			0.200
Non-Pre Pay State			0.400
1-year prepay (max 1 YSP)	1.250	or	0.750
2-year prepay (3/27,5/25 or Fixed)	1.000	or	0.500
Partial Prepay Buyout (no YSP)	1.250	or	0.800
Prepay Buyout (no YSP)	1.500	or	1.000

Property Type	Rate Adj
2-4 units	0.400

Occupancy	<=70%	70.01 - 80.00%	>80%
2nd Home (Standalone only)	0.125	0.250	0.375
Non-Owner Occupancy **(Minimum FICO 560)**	1.100	1.350	1.600

Secondary Financing (CLTV > LTV)	
Credit Score >= 660	0.900
Credit Score < 660	1.550

UW Fees	UW Fee		UW Buyout
$300,000 +	$850	or	0.200
$125,000 - $299,000	$850	or	0.300
<$125,000	$695	or	0.500

LTV Max Eligibility Adjustments		AA+	AA	A	B	C	CC
Non-Owner, Full Doc		-5	-10	-10	-10	-10	-10
Non-Owner, Stated	(Max 90%, no CC)	-5	-10	-10	-10	-10	-10
3-4 Units, Full Doc	(Max 90%)	-5	-5	-5	-5	-5	-5
3-4 Units, Stated	(Max 90%)	-5	-5	-5	-5	-5	-5
Second Home > 80% *, Full Doc		-5	-5	-5	-5	-5	-10
Second Home > 80%, Stated	(Max 90%, no CC)	-5	-5	-5	-5	-5	-5

No Doc Maximum LTVs: 660 - 80%, 680 - 85%
FTHB - 660 - 80%; primary residence purchases only

Stated Wage Earner: Max 80% for 560-599, 85% for 600-619, 90% for 620-679

5/3/2007