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Before the Financial Services and General Government Subcommittee of the U.S.
House Appropriations Committee
“Consumer Protection in Financial Services: Subprime Lending”

February 28, 2008

Chairman Serrano, Ranking Member Regula, and members of the Financial Services and General Government Subcommittee, thank you for holding this hearing and inviting us to testify before you today. My remarks will focus on issues in the subprime mortgage market, where improved legislation and oversight would strengthen consumer protections long-term and, more immediately, reduce the economic damage caused by the massive subprime foreclosures plaguing our economy today.

I serve as the President of the Center for Responsible Lending (CRL) (www.responsiblelending.org), a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self Help (www.self-help.org), which comprises a certified community development financial institution and subprime lender that makes loans to people with less-than-perfect credit.

Since 1985, 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, with an annual loan loss rate of less than one percent. Over the years, this Committee has provided valuable support for our lending through appropriations to the Community Development Financial Institution Fund, a grant program administered by the Treasury Department. Chairman Serrano, we are grateful for that support and particularly for your leadership last year in advocating for an increased appropriation for the CDFI Fund. It is a sound investment of public monies. We are proud to report that Self-Help has leveraged federal grants to increase homeownership, expand opportunities for small businesses, and strengthen communities in a variety of ways. (See “Self Help Impact,” attached as an appendix.)

Self-Help and similar CDFIs are lenders who are in the business of making constructive loans to people who would not qualify for mainstream financing. However, there is a big difference between responsible community development lending and the typical type of subprime activity that developed in recent years. CDFIs provide loans that are designed to be sustainable; the majority of subprime lenders in recent years placed a low priority on sustainability. The proof is in the massive foreclosures we are seeing in the subprime industry today—the worst rate of home losses since the Great Depression.

A year ago this month, our organization appeared before the Senate Banking Committee to sound an alarm about the subprime market. At that time, we had just released new research predicting that due to predatory and unsustainable lending practices, 2.2 million
families had lost or were likely to lose their homes to foreclosure. Our analysis showed that those lending practices would cause a crisis in the housing market, and that projection has become all too real.

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

In the context of this hearing, I believe it is important to outline why subprime lending, overall, has produced such disastrous results—not only for the families who received these loans, but for our economy as a whole. The following facts are some key factors in understanding the crisis we are facing today:

- **Magnitude.** The massive foreclosures the nation is experiencing today go well beyond any level seen in the modern mortgage market. Even with a strong policy response, many communities will be recovering from the economic devastation for years to come.

- **No net gain in ownership.** The majority of subprime loans have been refinances—not loans used for purchasing homes. Subprime mortgages made between 1998 and 2006 have not produced any net increase in the rate of homeownership.2

- **Reckless underwriting.** Lenders and brokers compromised basic, common sense underwriting principles in order to boost their loan volume. Loan originators made their money up front, and they had incentives to market loans that would attract higher prices on Wall Street. The riskier the loan, the higher the value in the secondary market. Unsustainable mortgages became standard in the subprime market not because of consumer demand, but because lenders were responding to Wall Street demand for high-risk products that produced a higher return for investors.

- **Dangerous loan products.** At the same time the industry lowered its standards for qualifying borrowers, it also aggressively marketed riskier types of adjustable-rate mortgages (ARMs). The most well known of these products is the hybrid ARM, often known as a “2/28” or “2/27.” Another risky product is the payment option adjustable-rate mortgage (POARM), which allows people to make monthly payments that do not cover principal and interest. With a POARM, the homeowner can actually end up owing more on the home over time instead of less. Subprime lenders and brokers billed themselves as professionals who could
offer the American dream, but too often they put Wall Street demand for high-risk investments ahead of the best interest of homeowners.

- **Passive federal regulators.** Federal financial regulators have been slow to respond. Even when there were clear warning signs that subprime lending was out of control, banking regulators (with some exceptions), and the Federal Reserve, which had authority over the entire market, remained largely passive, and missed an opportunity to take a leadership role in curbing subprime abuses. As the problem grew out of hand, federal regulators were equally passive about the contributory role that the secondary mortgage market played.

Some federal regulators have tried to justify the lack of response by arguing that the problem was largely confined to non-federal, non-depository lenders. It is the case that many of the most egregious lending abuses in the subprime market were perpetrated by non-bank financial institutions, which are subject to state regulation, and to enforcement by state attorneys general and the Federal Trade Commission (FTC). Though more could have been done on that front as well, the states and the FTC did bring major enforcement actions against top market players, despite limited resources to deal with a rapidly growing industry.  

And, in some instances, states’ efforts were hampered by increasingly aggressive assertions of federal preemption. At the end of the day, the national regulatory response was largely missing, both for the origination side of these deals, and for the buying side of these deals.

The sad truth is that consumers have had very little protection against abusive subprime lending, particularly on the federal level. Because most subprime lenders do not keep their mortgages, but sell them to Wall Street investors, lenders did not need to care about the quality of their loans. And because federal law did not keep up with the abuses, subprime lenders essentially had a free pass to flood the market with reckless loans.

Market incentives have been stacked against homeowners, but from personal experience we know that it is possible to serve the subprime mortgage market responsibly, affordably and ethically. Today the House is considering reasonable policies that would not only help struggling homeowners, but would also help mitigate economic damage and strengthen the economy as a whole. These solutions, discussed in more detail below, are to (1) permit judges to fix distressed home loans (H.R. 3609); (2) establish common-sense, enforceable lending standards that would restore discipline to both originators and Wall Street to prevent the subprime crisis from happening again; and (3) increase the resources available for FTC’s enforcement actions against abusive lending practices by market players under its jurisdiction.

**Magnitude of Problem**
Fifteen months ago, CRL estimated that 2.2 million families who secured subprime loans made from 1998 through 2006 have lost their home or will lose it in the future. Nothing in the past year has diminished this concern, and our most recent analysis shows that 2.26 million homes will be lost, primarily this year and next, if nothing is done. Indeed, a
recent Fitch report projects that 47% of the outstanding subprime loans originated in 2006 will be foreclosed, along with more than 40% of outstanding subprime loans originated in the first half of 2007.\footnote{7}

Foreclosures have risen drastically in every region in the country, hitting areas with a high concentration of subprime lending particularly hard. Chairman Serrano and Ranking Member Regula, I am sure you are aware that your own districts are at risk of suffering significant damage from foreclosures. In the 16\textsuperscript{th} District of Ohio, 28% of all mortgages originated during 2005 and 2006 were subprime loans, and we project that one in six subprime loans in the district will ultimately end in the loss of a home from foreclosure. In the 16\textsuperscript{th} District of New York, the risk is even more severe given that subprime lending rose to 42% of all mortgages made in ’05 and ’06. The result will be a high level of home losses, with more than one in five subprime loans in the district ultimately ending in foreclosure.

The subprime problem is not confined to the people who lose their homes, but it also spills over to their neighbors. When a home goes into foreclosure, the negative economic and social effects extend to surrounding neighbors and the wider community. The "spillover effects" are startling. In CRL's report on this "spillover effect,"\footnote{8} we have projected that, nationally, foreclosures on subprime home loans originated in 2005 and 2006 will have the following impact on the neighborhoods and communities in which they occur:

- 40.6 million neighboring homes will experience devaluation because of subprime foreclosures that take place nearby.
- The total decline in house values and tax base from nearby foreclosures will be $202 billion.
- Homeowners living near foreclosed properties will see their property values decrease $5,000 on average.

This is a dramatic reduction in the tax base of local and regional economies – a loss that exceeds the gains offered by the recent $145 billion economic stimulus package by nearly 40%. California, New York, Florida and Illinois, respectively, rank the highest in property devaluations with Maryland (6\textsuperscript{th}), Virginia (9\textsuperscript{th}), Michigan (16\textsuperscript{th}), Ohio (18\textsuperscript{th}), and Wisconsin (22\textsuperscript{nd}) all ranking among the top 24 states facing declines.

While some argue that “the market is correcting itself,” the signs are more ambiguous. The volume of subprime originations has slowed considerably, but there is strong evidence that abusive lending continued long after the subprime crisis had become apparent. Among subprime loans that were originated and sold on the secondary market in 2007, there was still a significantly high portion with dicey terms that increase risk of foreclosure: 69% had adjustable interest rates; 40% had not required proof of income; and 67% had prepayment penalties.\footnote{9} Although these types of loans are now less widely available for financially vulnerable borrowers, the subprime mortgage market as
currently structured doesn’t have adequate incentives to change its practices. As long as
the subprime market continues running without adequate rules, brokers and lenders will
continue to make any type of loan that Wall Street will buy. The market may tighten up
temporarily, but with so much money at stake, future abuses are inevitable.

A Net Loss in Ownership
One might be able to justify the enormous losses stemming from subprime lending if
those loans had produced overall gains in homeownership. Unfortunately, that is not the
case. Over the past nine years, the subprime market has produced more than $3 trillion in
home loans, but contrary to industry assertions, these loans have not resulted in a net gain
in homeownership. Between 1998 and 2006, only about 1.4 million first-time home
buyers purchased a home with a subprime loan. However, during the same period, over
2.2 million borrowers who obtained subprime loans will lose or have already lost their
home to foreclosure.10

The result is that since 1998, subprime lending has led to a net loss of homeownership for
over three-quarters of a million families. In fact, subprime lending has led to a net loss of
homeownership in every year of the past nine. (For more details, see the full report at

Reckless Underwriting
It is widely recognized today, even within the mortgage industry, that lenders became far
too lax in qualifying applicants for subprime loans.11 They underwrote ARMs only to the
initial rate, which means they did not even consider how homeowners would be able to
pay their loans once the payment adjusted upward. Even worse, many lenders qualified
borrowers without any verification of income at all through so-called “stated-income” or
“no-doc” loans. Fitch has noted that “loans underwritten using less than full
documentation standards comprise more than 50 percent of the subprime sector.”12
These “stated doc” loans added to the cost for borrowers. Even borrowers who could—and
were quite willing to—document their income were steered into these loans by the
originators because of the price premium attached to stated-doc loans. Some lenders
even offered a product called “Stated-Income W-2s” – meaning a higher-cost loan
product was sold to wage earners who could perfectly easily verify their salaries.13
Stated-income products also made it easier for originators to qualify borrowers for loans
without underwriting for ability to repay the loan.

Dangerous Loan Products
Subprime lenders flooded the market with dangerous loan products, making them
appealing to borrowers by marketing low monthly payments based on low introductory
teaser rates. The most well known of these products is the hybrid adjustable-rate
mortgage (ARM), often known as a 2/28 or 3/27. This type of loan begins with a fixed
interest rate for either two or three years, then converts to a higher interest rate pegged to
an index such as LIBOR. The loan then continues to adjust every six months, which, if
the index rises, can be as much as 50% more than the original rate. Another complex
product that has put many low-income families at risk is the POARM, mentioned above.
POARMs allow people to pay a minimum payment that does not cover principal and
interest, which can make their loan balance grow larger during the period when the
minimum payment is being made (i.e., the loan “negatively amortizes”). Unfortunately,
lenders like Countrywide offered these loans to borrowers for whom they were not well
suited, structured the products so that the payments substantially increase in five years or
less when they hit their negative amortization cap, used excessive teaser interest rates to
lure borrowers to the product, and failed to document income. Unlike 2/28s, the
POARMs that were poorly underwritten are largely Alt-A mortgages (considered by
investors to have slightly higher risk than prime loans) as opposed to subprime.

Passive Regulators
With some notable exceptions, key federal regulators were slow to act in response to the
rapid growth of an increasingly reckless—and, as we now see—destabilizing portion of
the mortgage market. (The subprime share of the mortgage market grew from 12% of the
mortgage market [$160 billion] in 1999 to more than 21% [$600 billion] in 2006.14)

The most recent federal law aimed at curbing excesses in the subprime market was
enacted over a dozen years ago in 1994 (the Homeownership Equity Protection Act, or
“HOEPA”). While it was largely successful in curbing targeted problems, the law was
aimed at a narrow range of abuses that were prevalent at that time. HOEPA includes
flexibility to deal with inevitable subsequent predatory practices that would develop by
giving the Federal Reserve Board the authority to issue rules aimed at addressing unfair
and deceptive practices in the mortgage market.15 Yet the FRB’s proposed rules to tackle
today’s abuses – making loans without attention to the borrower’s ability to pay the loan,
the perverse incentives to steer homeowners into higher-priced loans, the prepayment
penalties that lock borrowers into higher priced loans – were just published in January of
2008.

While the Board’s proposed rules offer stronger protections on some abusive practices,
we fear they would not be adequate to curb some of the most fundamental causes of
today’s crisis. For example, the proposal falls short in addressing the perverse market
incentive (called “yield-spread premiums) that encourages brokers to place borrowers
into higher-priced loans, and also fails to sufficiently address abusive prepayment
penalties that both increase costs and the risk of foreclosure for borrowers.16 The Board’s
proposed rules are also far too late for many homeowners, and they are unlikely to
become to become effective until sometime in the second half of 2008. Another action
that occurred late in the subprime crisis came only last July, when the federal financial
regulators collectively issued a “guidance” that addressed several key components of
reckless underwriting.17

The lack of protections against abusive lending have been particularly damaging in a
market that offers strong incentives to take advantage of borrowers. Subprime mortgage
brokers, lenders, securitizers, and investors are operating in a market that rewards
business practices that directly undermine homeowners and sustainable homeownership.
Some of the federal regulators have been more aggressive than others in seeking to act,
although arguably the focus on origination practices rather than the “market-making”
practices of financial institutions who supported poor lending practices by buying
questionable loans may have had the unintended consequence of magnifying the spillover impact into the larger economy, as major federally chartered institutions have found it necessary to write down billions of dollars in losses.\textsuperscript{18}

Markets function effectively when transactions are likely to benefit all parties involved, but we don’t have that situation in subprime lending. For years the mortgage industry has lobbied against subprime lending regulation and legislation, arguing that credit markets would shrink as a result of such regulation. Ironically, we have seen the credit markets become more restrictive in response to the lack of adequate regulation and the reckless lending that followed; in fact, it has largely shut down. If subprime lenders had been subject to the same kind of rules that responsible mortgage lenders have always followed, the nation would not be bearing the costs of this crisis today.

Solutions
We urge Congress to stand up for homeowners by seeking meaningful solutions to the subprime crisis that will help our national economy recover and prevent this kind of fiasco in the future. Any effective solution will involve reducing foreclosures on existing loans, and also addressing perverse market incentives that could cause a recurrence of this situation in the future. It has become abundantly clear that to let the foreclosure crisis play out in a continued downward spiral is not acceptable. The consequences to neighbors, communities, and the economy as a whole are too great to do nothing. The problem has metastasized too much for any one solution, but we believe that key proposals discussed below are within Congress’ reach this session.

Permit judges to fix distressed home loans. The best solution to the current mortgage crisis is a small change to the bankruptcy code that would allow courts to make limited modifications to a mortgage loan when the borrower is facing foreclosure, ensuring that the borrower stays in their home and the lender continues to receive a payment stream. This change, H.R. 3609, has passed the House Judiciary Committee in a bipartisan compromise struck by Chairman Conyers and Representative Chabot. Because the compromise legislation is limited to loans already in existence, it will have no detrimental impact on the cost or availability of credit going forward.

The proposal to allow court-supervised modifications for borrowers facing foreclosure does not implicate the 2005 Bankruptcy Code changes, but rather relates to an older provision of the law. Right now, wealthy investors and speculators may receive loan modifications in bankruptcy proceedings for the debt they owe on their yachts, vacation homes and investor properties. Yet current law bars middle-class homeowners from receiving a loan modification to save the roof over their heads. Permitting bankruptcy judges to modify loans on primary residences could prevent as many as 600,000 foreclosures. (In reality, this remedy will accomplish its objective even without requiring most of these families to actually file for bankruptcy. Changing the Code will provide a template for modification and will give servicers the precedent and protection they need from lawsuits by tranches of investors who might otherwise object.)
Making this small fix to the bankruptcy code will be a win-win for homeowners, lenders, neighbors, taxpayers and the economy as a whole. Homeowners can stay in their homes. Lenders will be guaranteed the fair market value of their house, which is more than they would receive at foreclosure sale, and without the lengthy delays and expenses associated with foreclosure. Finally, and crucially, loans can be modified quickly and effectively.

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

**Increase the resources available for FTC’s enforcement actions against abusive lending practices by market players under its jurisdiction:** Key federal regulators are not funded by Congressional appropriations, but rather by assessments on the banks they regulate. Consequently, other Committees have more direct oversight over their responses. The Federal Trade Commission, however, is funded largely by appropriations. Although it does not have market-wide authority to enforce the federal law against unfair and deceptive acts and practices (UDAP) in the marketplace, it does have a significant number of actors within its jurisdiction. We see now that reckless lending and misleading sales practices in the subprime and nontraditional marketplace have consequences far beyond the homeowner and the loan originator. It would be an investment in our economy to increase the resources available to the FTC to enhance its enforcement capacity.

**Conclusion**

The subprime lending system has failed millions of middle-class families. These are people who were trying to do everything right: they worked hard at their jobs, they took care of their children, and they were seeking a more secure future. Now these families are on the verge of losing any semblance of security, and we all will be worse off as a result.

While many homes can no longer be saved, policymakers have a number of tools at their disposal to mitigate the harm caused by the current situation, and prevent it from happening again in the future. We greatly appreciate your interest in these issues, and we look forward to working with you to protect homeowners and promote sustainable homeownership.
END NOTES

1 “Subprime Spillover: Foreclosures Cost Neighbors $202 Billion; 40.6 Million Homes Lose $5,000 on Average,” Center for Responsible Lending issue brief (rev. January 18, 2008).


3 States or the Federal Trade Commission (or both in cooperation) brought enforcement actions against First Alliance Mortgage Company, Associates (acquired by Citigroup), Household (acquired by HSBC), and Ameriquest. In doing so, the states and the FTC took on the top market-share subprime originators in all years between 1997 and 2005 save one.


5 Legislative and regulatory responses to changes in the nature of the problems in the subprime market at the federal level have been slow to non-existent, while states have shown more nimbleness. Several states have enacted so-called “mini-HOEPAs” since 1999 to close the loopholes in the 1994 federal law (the “Homeownership and Equity Protection Act”). As the industry’s underwriting got more reckless, and the products sold shifted to the riskier adjustable-rate mortgages, states again moved more rapidly to address the new model of abusive lending and reckless lending as Ohio, Minnesota, North Carolina, Maine, Illinois, and Colorado have enacted laws taking aim at these practices since May, 2006.

6 Center for Responsible Lending: The Impact of Court-Supervised Modifications on Subprime Foreclosures: United States (February 25, 2008).


8 See note 1.

9 “Subprime Guidance Did Little to Diminish ARM Share,” Inside B&C Lending (February 15, 2008).

10 Our numbers are conservative for several reasons. First, we use data from a proprietary database, and the share of loans used to purchase homes (versus refinances) among these investment mortgages was higher than in the market as a whole. Second, our analysis compares subprime first-lien, owner-
occupied loans made to first-time homebuyers with CRL’s foreclosure projections in a research report issued in December 2006, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowner (issued by the Center for Responsible Lending). The foreclosure projections in Losing Ground are based on conservative assumptions. In fact, since we issued the report, other analyses suggest that foreclosures in the subprime market could actually be higher than indicated by our analysis. See, e.g., Lehman Brothers report that projects 30% losses over time for subprime loans originated in 2006. See Mortgage Finance Industry Overview (December 22, 2006), p. 1.

11 See, e.g., Vikas Bajaj and Christine Haughney, “Tremors at the Door – More People with Weak Credit are Defaulting on Mortgages,” The New York Times, citing Inside Mortgage Finance (January 26, 2007). A recent Fitch publication found that low-doc subprime loans made in 2006 were 50% more likely to be sixty or more days delinquent 15 months after origination than their low-doc subprime counterparts from 2000 (delinquency rates were roughly 18% and 12% respectively). Adding concern, the 2006 group of loans actually carried credit scores that were about 20 points higher than the 2000 cohort. See Glenn Costello, Update On U.S. RMBS: Performance, Expectations, Criteria, p. 13, Fitch Ratings (undated, est. Feb. 2008).


13 For example, an October, 2006 rate sheet from New Century had a “stated wage earner” product that added 30 basis points (.3%) to the interest rate over the price of a fully documented loan. (Rate sheet on file with CRL.)


15 15 USC § 1639l. The Federal Trade Commission also has authority to promulgate regulations prohibiting unfair and deceptive acts and practices, but there are two structural hurdles impeding its capacity to do so with respect to mortgage lending. First, its rules apply only to non-depository lenders, so, unlike the FRB’s authority under HOEPA, its rules would not cover the entire mortgage market. Second, the statutory procedure which the FTC must follow to promulgate rules regarding unfair and deceptive acts and practices is significantly more cumbersome, lengthy, and resource-intensive than the normal Administrative Procedures Act notice-and-comment rule-making. See 15 USC § 57a. Indeed, the FTC’s credit practices rule took nearly a decade, from 1975 to 1985, to wend its way through its special UDAP rule-making process.


17 Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37569 (July 10, 2007), effective July 10, 2007. (Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration.) These were issued as “guidances,” not as rules. There were earlier interagency guidances addressing subprime lending, but they failed to address the core problems. Interagency Guidance on Subprime Lending (March 1, 1999), and Expanded Guidance for Subprime Lending Programs (2001).