Testimony of Martin Eakes, CEO
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Before the U.S. Senate Committee on Banking, Housing and Urban Affairs
"Preserving the American Dream: Predatory Lending Practices and Home Foreclosures"

February 7, 2007[*]

Mr. Chairman and members of the Committee, thank you for holding this hearing to examine the problems of foreclosures and predatory lending in the subprime market, and thank you for the invitation to speak today.

I testify as CEO of Self-Help (www.self-help.org), which consists of a credit union and a non-profit loan fund. For the past 26 years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans. Self-Help has provided over $4.5 billion of financing to over 50,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across the country, with an annual loan loss rate of under one percent. We are a subprime lender. In fact, we began making loans to people with less-than-perfect credit in 1985, when that was unusual in the industry. We believe that homeownership represents the best possible opportunity for families to build wealth and economic security, taking their first steps into the middle class. I emphasize this point because expanding access to homeownership has been central to Self Help's mission and it would be counter to everything I believe to recommend any policies that would diminish beneficial credit to families seeking a better future.

I am also CEO 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 began as a coalition of groups in North Carolina that shared a concern about the rise of predatory lending in the late 1990s.

The subprime mortgage market today is a quiet but devastating disaster. The ultimate effects are very much like Hurricane Katrina, as millions of citizens lose their homes and the fabric of entire communities is threatened. The difference is that this disaster in the subprime market is occurring every single day across the country, house by house and neighborhood by neighborhood. Our analysis of subprime mortgages made in recent years shows that 2.2 million families will lose their home to foreclosure—foreclosures that were, for the most part, predictable and entirely avoidable through more responsible lending practices. As housing appreciation slows down in many areas of the country, it is clear that the problem will only grow worse. All indications are that subprime mortgage loans are headed toward the worst rate of foreclosures in modern mortgage market history.[1]

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[*] Editor's note: This copy includes a minor technical correction made after the report was submitted to the Committee.

Why does a foreclosure epidemic in the subprime mortgage market matter? First, subprime mortgages are no longer a niche market; they have become a significant share of all new mortgages made in America, now making up well over 20 percent of all home loans originated and currently representing $1.2 trillion of mortgages currently outstanding.[2] Second, homeownership is the best and most accessible way most families have to acquire wealth and economic security. If home loans are actually setting citizens back rather than helping them build for the future, there are serious ramifications for local economies and the nation as a whole. The problem is particularly serious for communities of color, since more than half of African-American and 40 percent of Latino families who get home loans receive them in the subprime market.[3] If current trends continue, it is quite possible that subprime mortgages could cause the largest loss of African-American wealth in American history.

Under typical circumstances, foreclosures occur because a family experiences a job loss, divorce, illness or death. However, the epidemic of home losses in today's subprime market is well beyond the norm. Subprime lenders have virtually <u>guaranteed</u> rampant foreclosures by approving risky loans for families while knowing that these families will not be able to pay the loans back. There are several factors driving massive home losses:

- **Risky products**. Subprime lenders have flooded the market with high-risk loans, making them appealing to borrowers by marketing low monthly payments based on low introductory teaser rates. The biggest problem today is the proliferation of hybrid adjustable-rate mortgages ("ARMs," called 2/28s or 3/27s), which begin with a fixed interest rate for a short period, then convert to a much higher interest rate and continue to adjust every six months, quickly jumping to an unaffordable level.

- **Loose underwriting**. It is widely recognized today, even within the mortgage industry, that lenders have become too lax in qualifying applicants for subprime loans.[4] Especially troubling is the practice of qualifying borrowers without any verification of income, not escrowing for property taxes and hazard insurance, and failing to account for how borrowers will be able to pay their loan once the payment adjusts after the teaser period expires.

- **Broker abuses**. Today's market includes perverse incentives for mortgage brokers to make high-risk loans to vulnerable borrowers. Brokers often claim that borrowers engage them for their knowledge and generally believe that brokers are looking for the best loan terms available. Yet brokers also claim they do not need to serve the borrower's best interests.

- **Investor support**. Much of the growth in subprime lending has been spurred by investors' appetite for high-risk mortgages that provide a high yield. The problem is that the investor market reaction occurs only after foreclosures are already rampant and families have lost their homes.

- **Federal neglect**. Policymakers have long recognized that federal law—the Home Ownership and Equity Protection Act of 1994 (HOEPA)—governing predatory lending is inadequate and outdated. Although the Federal Reserve Board (hereinafter, the "Board") has the authority to step in and strengthen relevant rules, they have steadfastly refused to act in spite of years of large-scale abuses in the market. For the majority of subprime mortgage providers, there are no consequences for making abusive or reckless home loans.

I respectfully submit that there are simple and effective policy solutions to stop destructive lending practices in the subprime market and return to sound lending practices. CRL makes the following five recommendations:

1. Restore safety to the subprime market by imposing a borrower "ability to repay" standard for all subprime loans. Recently federal banking regulators issued "Guidance on Nontraditional Mortgage Product Risks," which recognizes the danger posed by risky loan products and imprudent underwriting practices.[5] This Guidance should apply to all subprime ARM loans and non-traditional products. Specifically, the agencies should affirm that this Guidance covers the most widely destructive type of loan today: hybrid adjustable-rate mortgages in the subprime market (2/28s and 3/27s). These loans now make up the vast majority of subprime loans, and they have predictable and devastating consequences for the homeowners that receive them.

2. Require mortgage brokers to have a fiduciary duty to their clients. This simply means giving brokers the explicit responsibility of serving the best interests of the people who pay them. Brokers are now managing the most important transaction most families ever make. Their role is at least as important as that of lawyers, stockbrokers and Realtors—professions that already have fiduciary standards in place.

3. Require the Federal Reserve to act, or address abuses through the Federal Trade Commission. The major federal law designed to protect consumers against predatory home mortgage lending is HOEPA, which has manifestly failed to stem the explosion of harmful lending abuses that has accompanied the recent subprime lending boom. As I will describe below, through HOEPA, Congress did provide the Board with significant authority to address these problems through regulation, but to date the Board has not used this authority. Given the Board's record, Congress should give parallel authority to the Federal Trade Commission to address mortgage lending abuses that have gone on for too long.

4. Require government-sponsored enterprises to stop supporting abusive subprime loans. Currently Fannie Mae and Freddie Mac are purchasing the senior tranches of mortgage-backed securities backed by abusive subprime loans. By doing so, they are essentially supporting and condoning lenders who market abusive, high-risk loans that are not affordable. This is clearly counter to the mission of those agencies. The agencies should cease purchasing the securities, the Office of Federal Housing Enterprise Oversight (Ofheo) should prohibit their purchase, and the U.S. Department of Housing and Urban

Development (HUD) should stop providing credit for these securities under HUD's affordable housing goals.

5. Strengthen protections against destructive home lending by passing a strong national anti-predatory lending bill. HOEPA has not kept up with the evolution of abuses in the market, and needs to be updated and strengthened. However, the mortgage market is constantly changing, and it is impossible for any single law to cover all contingencies or to anticipate predatory practices that will emerge in the future. Any new federal law must preserve the right of the states to supplement the law, when necessary, to address new or locally-focused lending issues.

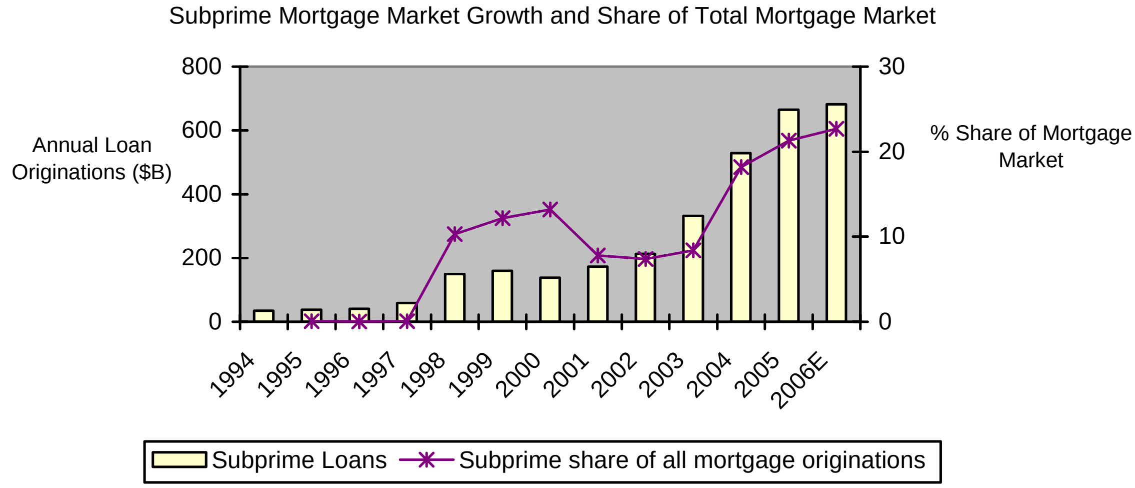
While there is a strong need for comprehensive reforms of the subprime mortgage market, including weeding out abuses in how mortgage servicers handle monthly payments, my primary focus in these comments will be on loan origination practices and how high-risk loans in the subprime market are supported and regulated.

I. Background: The Subprime Market and the Evolution of Predatory Lending[6]

A. The Subprime Market and the Evolution of Predatory Lending

The subprime market is intended to provide home loans for people with impaired or limited credit histories. In addition to lower incomes and blemished credit, borrowers who get subprime loans may have unstable income, savings, or employment, and a high level of debt relative to their income.[7] However, there is evidence that many families—a Freddie Mac researcher reports one out of five—who receive subprime mortgages could qualify for prime loans, but are instead "steered" into accepting higher-cost subprime loans.[8]

As shown in the figure below, in a short period of time subprime mortgages have grown from a small niche market to a major component of home financing. From 1994 to 2005, the subprime home loan market grew from $35 billion to $665 billion, and is on pace to match 2005's record level in 2006. By 2006, the subprime share of total mortgage originations reached 23 percent.[9] Over most of this period, the majority of subprime loans have been refinances rather than purchase mortgages to buy homes. Subprime loans are also characterized by higher interest rates and fees than prime loans, and are more likely to include prepayment penalties and broker kickbacks (known as "yield-spread premiums," or YSPs).



Source: Inside Mortgage Finance

When considering the current state of the subprime market, it is useful to understand how predatory lending has evolved over the past 15 years. When widespread abusive lending practices in the subprime market initially emerged during the late 1990s, the primary problems involved equity stripping—that is, charging homeowners exhorbitant fees or selling unnecessary products on refinanced mortgages, such as single-premium credit insurance. By financing these charges as part of the new loan, unscrupulous lenders were able to disguise excessive costs. To make matters worse, these loans typically came with costly and abusive prepayment penalties, meaning that when homeowners realized they qualified for a better mortgage, they had to pay thousands of dollars before getting out of the abusive loan.[10]

In recent years, when the federal government failed to act, a number of states moved forward to pass laws that address equity-stripping practices. Research assessing these laws has shown them to be highly successful in cutting excessive costs for consumers without hindering access to credit.[11] The market has expanded at an enormous rate during recent years even while states reported fewer abuses targeted by new laws. In addition, the leadership shown by states has helped encourage the adoption of best practices by responsible lenders and leaders in the mortgage industry. Today, for example, single premium credit insurance has virtually disappeared from the market, upfront fees are much lower than they used to be, and prepayment penalties have become less costly, on average, and last for a shorter period of time.

In spite of these successes, no one would say that predatory lending has been eliminated. <u>Prepayment penalties</u> continue to be imposed on 70 percent of all subprime loans,[12] and many other "old" predatory practices are still alive and well in today's marketplace: "<u>Steering</u>," when predatory lenders push-market borrowers into a subprime mortgage even when they could qualify for a prime loan; <u>kickbacks to brokers</u> (yield-spread premiums) for selling loans with an high interest rate higher than the rate to which the borrowers actually qualified; and loan "flipping," which occurs when a lender refinances a loan without providing any net tangible benefit to the homeowner.

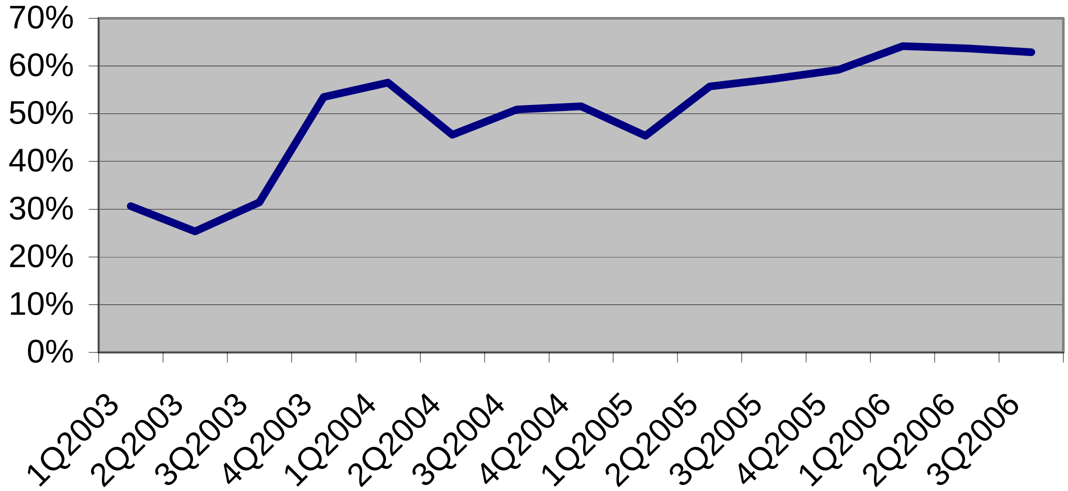
In addition, we now have a second generation of subprime lending abuses: high-risk loan products that were never intended for families who already have credit problems (discussed in more detail later in this testimony). The risks posed by these loans are magnified further because they are designed to generate refinances. These loans typically begin with a low introductory interest rate that increases sharply after a short period of time (one to three years) and fails to account for escrows for required taxes and insurance. The very design of these loans forces struggling homeowners to refinance to avoid unmanageable payments. In other words, the prohibition against flipping that many states instituted has been defeated by the design of a particular subprime mortgage product that has dominated the market in recent years.

While multiple refinances boost volume for lenders, these transactions often provide only temporary relief for families, and almost inevitably lead to a downward financial spiral in which the family sacrifices equity in each transaction. These dangerous subprime hybrid ARM loan products and the ensuing refinances make a high rate of foreclosures not only a risk, but also a certainty for far too many families. And the likelihood of foreclosure will only increase as housing prices slow and accumulated equity is no longer available to refinance or sell under duress.

B. Foreclosures in the Expanding Subprime Market

In the United States, the proportion of mortgages entering foreclosure has climbed steadily since 1980, with 847,000 new foreclosures filed in 2005.[13] In 2006, lenders reported 318,000 new foreclosure filings for the third quarter alone, 43 percent higher than the third quarter of 2005.[14] In the past 18 months, there have been frequent stories in the media about risky lending practices and surges in loan defaults, especially in the subprime market.[15]

Subprime Foreclosure Starts as a Percent of Total Conventional Foreclosure Starts



Source: MBA National Delinquency Surveys

Figure 2 shows that foreclosure filings on subprime mortgages now account for over 60 percent of new conventional foreclosure filings reported in the MBA National Delinquency Survey. This fact is striking given that only 23 percent of current originations are subprime, and subprime mortgages account for only 13 percent of all outstanding mortgages.

Some have applauded the growth in subprime lending as a positive break-through in extending credit. To be sure, the community reinvestment movement, civil rights activists, and others—including Self Help—have fought for years to bring investment to communities that have lacked access to vital capital.

Yet this increased access has come at great cost to many families, given current subprime lending practices. <u>The pressing issue today is less the availability of home-secured credit than the terms on which it is offered</u>. For the average American, building wealth through homeownership is the most accessible path to economic progress, but progress is not achieved when a family buys or refinances a home only to lose the home or get caught in a cycle of escalating debt.

For most families, foreclosure is a last resort, often coming in the wake of unemployment, illness, divorce, or some other personal event that causes a drop in income. However, in recent years there has been a surge in subprime foreclosures that cannot be explained by a change in employment levels or other factors that typically drive foreclosures. Instead, as widely discussed in the press during recent months, the consequences of loose underwriting practices in the subprime market are now exacerbated by a general slow-down in housing appreciation.

Researchers have examined the relationship between subprime lending and foreclosures, and the effects on local communities. Some of the strongest research has been conducted by the Woodstock Institute, which has analyzed subprime foreclosures in the Chicago area. Woodstock researchers have found high concentrations of subprime lending in zip-code areas that have a high proportion of minority residents.[16] Woodstock also has shown that "increases in high cost subprime mortgage lending have been the leading driver of skyrocketing foreclosure levels across the Chicago region."[17] Dan Immergluck (formerly on Woodstock's staff, now a professor at the Georgia Institute of Technology) and Geoff Smith of Woodstock also investigated the effects of subprime lending and foreclosures on neighborhoods. They found that in Chicago a foreclosure on a home lowered the price of other nearby single-family homes, on average, by 1.44 percent.[18] They also reported that the downward pressure on housing prices extended to houses that sold within two years of the foreclosure of a nearby house.

About two months ago my organization, the Center for Responsible Lending, published a report that represents the first comprehensive, nationwide research conducted on foreclosures in the subprime market. The report, "Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners," is based on an analysis of over six million subprime mortgages, and the findings are disturbing. Our results show that despite low interest rates and a favorable economic environment during the past several years, the subprime market has experienced high foreclosure rates comparable to the worst foreclosure experience ever in the modern prime market. We also show that foreclosure rates will increase significantly in many markets as housing appreciation slows or reverses. As a result, **we project that 2.2 million borrowers will lose their homes and up to $164 billion of wealth** in the process. That translates into foreclosures on one in five subprime loans (19.4 percent) originated in recent years. Taking account of the rates at which subprime borrowers typically refinance from one subprime loan into another, and the fact that each subsequent subprime refinancing has its own probability of foreclosure, this translates into projected foreclosures for **more than one-third of subprime borrowers**.

Another key finding in our foreclosure report is that subprime mortgages typically include characteristics that significantly increase the risk of foreclosure, regardless of the borrower's credit. Since foreclosures typically peak several years after a loan is originated, we focused on the performance of loans made in the early 2000s to determine what, if any, loan characteristics have a strong association with foreclosures. Our findings are consistent with other studies, and show what responsible lenders and mortgage insurers have always known: increases in mortgage payments and poorly documented income substantially boost the risk of foreclosure. For example, even after controlling for differences in credit scores, these were our findings for subprime loans made in 2000:

- Adjustable-rate mortgages had 72 percent greater risk of foreclosure than fixed-rate mortgages.
- Mortgages with "balloon" payments had a 36 percent greater risk than a fixed-rate mortgage without that feature.

- Prepayment penalties are associated with a 52 percent greater risk.
- Loans with no documentation or limited documentation of the applicant's income were associated with a 29 percent greater risk.
- And buying a home with a subprime mortgage, versus refinancing, puts the homeowner at 29 percent greater risk.

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

C. Disparate Impacts of Foreclosures

The costs of subprime foreclosures are falling heavily on African-American and Latino homeowners, since subprime mortgages are disproportionately made in communities of color. The most recent lending data submitted under the Home Mortgage Disclosure Act (HMDA) show that over half of loans to African-American borrowers were higher-cost loans, a measurement that serves as a proxy for subprime status.[19] For Latino homeowners, the portion of higher-cost loans is also very high, at four in ten. The specific figures are shown below:

Share of Higher Cost Mortgages by Race

Based on 2005 Data Submitted Under the Home Mortgage Disclosure Act

Group	No. of Higher-Cost Loans	% for Group	% of Total
African American	388,741	52%	20
Latino	375,889	40%	19
White	1,214,003	19%	61

Given the projected foreclosure rate of approximately one-third of borrowers taking subprime loans in recent years, this means that subprime foreclosures could affect approximately 12 percent of recent Latino borrowers and 16 percent of African-American borrowers. If this comes to pass, it is potentially the biggest loss of African-American wealth in American history.

However, while the negative impact of foreclosures falls disproportionately on communities of color, the problem is not confined to any one group. In absolute terms, white homeowners received three times as many higher-cost mortgages as African-American borrowers, and therefore will experience a significant number of foreclosures as well.

II. Factors Driving Foreclosures in the Subprime Market

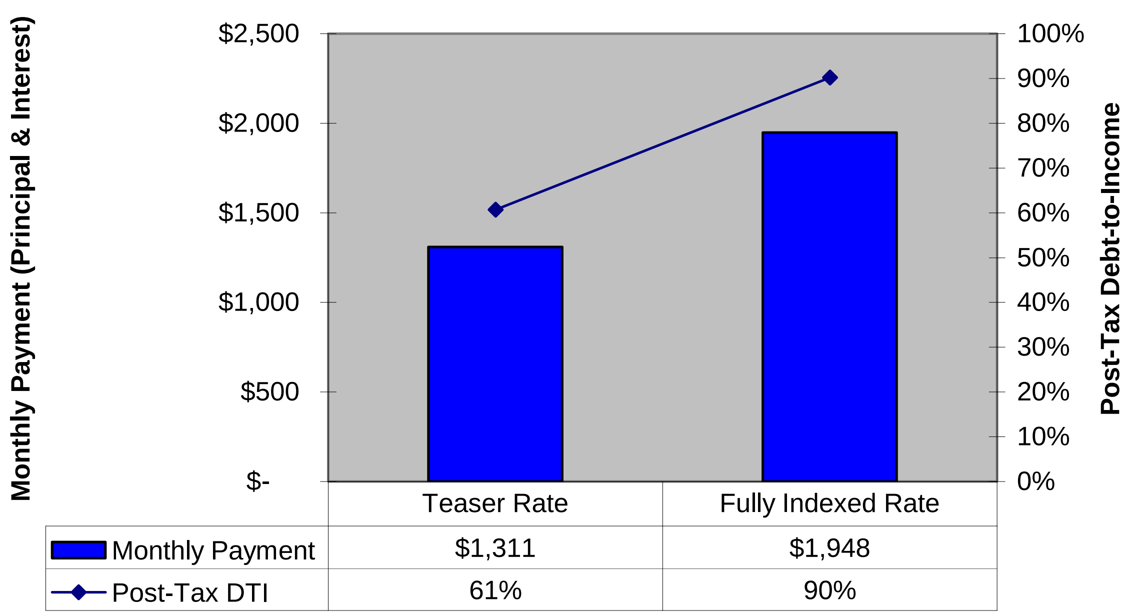
A. Risky Products: 2/28 "Exploding" ARMs

Subprime lenders are routinely marketing the highest-risk loans to the most vulnerable families and those who already struggle with debt. Because the subprime market is intended to serve borrowers who have credit problems, one might expect the industry to offer loan products that do not amplify the risk of failure. In fact, the opposite is true. Lenders seek to attract borrowers by offering loans that start with deceptively low monthly payments, even though those payments are certain to increase. As a result, many subprime loans can cause "payment shock," meaning that the homeowner's monthly payment can quickly skyrocket to an unaffordable level.

Unfortunately, payment shock is not unusual, but represents a typical risk that comes with the overwhelming majority of subprime home loans. Today the dominant type of subprime loan is a hybrid mortgage called a "2/28" that effectively operates as a two-year "balloon" loan.[20] This ARM comes with an initial fixed teaser rate for two years, followed by rate adjustments in six-month increments for the remainder of the term of the loan.[21] Commonly, this interest rate increases by between 1.5 and 3 percentage points at the end of the second year, and such increases are scheduled to occur even if interest rates in the general economy remain constant; in fact, the interest rates on these loans generally can only go up, and can never go down.[22] This type of loan, as well as other similar hybrid ARMs (such as 3/27s) have rightfully earned the name "exploding" ARMs.

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

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



For the 2/28 ARM shown in the chart above, we are making conservative assumptions that correspond with typical mortgages of this type. To make the example even more conservative, we are assuming no general increase in interest rates, even though rates have increased substantially in the past three years. The example is based on an introductory teaser rate of 6.85 percent and a fully indexed rate of 11.50 percent.[23] The loan amount used in this example was $200,000, and, given the common practice of extending loans where the pre-tax debt-to-income ratio is 50 to 55 percent, we assume that this homeowner had a pre-tax income of $31,452, which equates to a post-tax income of $25,901.

At the end of the introductory rate period, this homeowner's interest rate rose from 6.85 percent to 9.85 percent, and the monthly payments jumped from $1,311 to $1,716, and again six months later to $1,948, an increase of over $600 a month.[24] This would be a large increase for most families, and is a huge burden for a family that already struggles with debt. At $1,948, this leaves only $210/month for all other expenses – including property taxes and hazard insurance, food, utilities, transportation, healthcare, and all other family needs.

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

One would hope that this type of loan would be offered judiciously. In fact, hybrid ARMs (2/28s and 3/27s) and hybrid interest-only ARMs have become "the main staples of the subprime sector."[25] Through the second quarter of 2006, hybrid ARMs made up 81 percent of the subprime loans that were packaged as investment securities. That figure is up from 64 percent in 2002.[26]

Because of the proliferation of these loans, payment shock for subprime borrowers is a serious and widespread concern. According to an article in the financial press that ran a year ago, homeowners face increased monthly payments on an estimated $600 billion of subprime mortgages that will reset after their two-year teaser rates end.[27] Fitch Ratings calculated that by the end of 2006, payments would have increased on 41 percent of the outstanding subprime loans.[28]

Another key point about 2/28s in the subprime market is that they typically come with large up-front fees compared to adjustable-rate mortgages in the prime market.[29] Very few borrowers in the subprime market can pay these fees directly, so they are paid by financing them as part of the loan. This cuts into homeowners' equity, essentially reducing their share of ownership. In other words, subprime ARMs routinely find borrowers trading equity, or ownership, in exchange for the temporary benefit of lower interest payments.

Previously I mentioned that regulators recently issued proposed "Guidance on Nontraditional Mortgage Product Risks" that was a strong attempt to address concerns about high-risk loan products. However, the Guidance does not explicitly address 2/28s or other hybrid loans in the subprime market. This is a serious omission that runs counter to the Guidance's intent, which is to require lenders "to effectively assess and manage the risks" on loan products with the same characteristics as 2/28s. In particular, the Guidance focuses on loan products that defer interest payments.[30] On 2/28s and other subprime hybrid mortgages, the change in interest rates is typically so large when the introductory rate ends that these loan terms may properly be characterized as a contingent deferral of interest from early years to later years of the loan term.[31]

The magnitude of the interest rate deferral on subprime hybrid ARMs is significantly larger than that typically found in prime ARM loans. Just last month, Federal Reserve Board Governor Susan Bies reached a similar conclusion, stating, "Let's face it; a teaser loan really is a negative [amortization] loan because you don't pay interest up front."[32]

Other federal policy-makers have concluded that the Guidance should be extended to 2/28 hybrid ARMs. Federal Deposit Insurance Corporation Chair Sheila Bair recently stated:

> The underwriting standards in the alternative-mortgage guidance should apply to those [2/28s,] and lenders should make sure there's an ability to pay. …. [2/28s] were the type of mortgage that certainly was intended to be within the spirit of the alternative-mortgage guidance.[33]

It is important to note the insidious effect of limiting the Guidance to non-traditional mortgage products such as interest-only loans and option payment ARMs, to the exclusion of 2/28s. Interest-only loans made up only 21.7 percent of the subprime mortgage-backed securities in 2006, and subprime option ARMs have yet to be evidenced in substantial numbers. [34] In contrast, 2/28s and 3/27s are the dominant product in the subprime market – the market where the vast majority of abusive lending occurs and where HMDA data shows minorities to be disproportionately represented. By limiting the Guidance's protections to products that exist predominantly in the prime market, while failing to cover the most common product in the subprime market, the regulators have left a disproportionate share of minority borrowers without protection.

We recently analyzed a randomly selected sample of North Carolina deeds of trust to compare the potential payment shock of loans eligible for the Guidance and subprime loans that currently are not. We found that the payment shock of non-interest-only suprime hybrid ARMs exceeded that of prime interest-only loans, not to mention prime hybrid ARMs. In addition, we found three characteristics of subprime hybrid ARMs that make the payment shock worse than that of prime loans – the initial rate serves as a floor (i.e. the loan rates can only adjust higher), while the interest rates on prime loans can fall as well as increase; the loans fully adjust an average of 2.5 years after origination, versus 5 years for prime loans; and the loans adjust every six months after the teaser expires, versus every year for prime loans. Our findings suggest that subprime hybrid ARMs carry scheduled payment shocks that present formidable and often insurmountable hurdles to borrowers.[35]

I would like to thank the six members of the Banking Committee who sent a letter in early December to the federal regulators who issued the Guidance and to the CSBS expressing the view that "these [2/28] mortgages have a number of the same risky attributes as the interest-only and option-ARMs and, therefore, should be covered by the new Guidance."[36] Industry associations have largely opposed this change. I would respectfully disagree with many of the industry assertions about subprime ARMs, and a coalition of civil rights and consumer groups have recently sent a critique of the industry claims to this Committee (Attached as Appendix B).

Finally, before leaving the topic of 2/28s, I want to address the common assertion that consumers demand these types of loans and should carry all the responsibility for receiving unsuitable loan products. Through our experience at Self Help and CRL, we have seen that homeowners with subprime ARMs or other types of risky loans were almost never given a choice of products, but were instead automatically steered to these loans, and were given little or no explanation of the loan's terms.

Subprime lenders have indicated that the types of products they offer and how they underwrite them is largely investor-driven. Consider the frank acknowledgement by the chief executive of Ownit Mortgage Solutions, a state-licensed non-bank mortgage lender that recently filed for bankruptcy protection after investors asked it to buy back **well over one hundred million dollars worth** of bad loans. Ownit's chief executive, William D. Dallas "acknowledges that standards were lowered, but he placed the blame at the feet of investors and Wall Street, saying they encouraged Ownit and other supbrime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. 'The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,' he said. 'What would you do?'"[37]

These mortgage products are complicated financial instruments that are not widely understood outside the financing and investment communities. For most families, buying or refinancing a house is a rare event. Very few consumers have facility with concepts such as "fully-indexed rate," "negative amortization," "prepayment penalties," "yield-spread premiums," and "hybrid ARMs." Very few people are qualified to assess the implications of the reams of papers they sign when they close on a new loan. Mortgage brokers and lenders are the experts, and consumers should be able to trust them for sound advice and a suitable loan.

It is not hard to find examples of trust that was betrayed. One prominent example appeared recently in *The Washington Post*, which published an article about a barely literate senior citizen who was contacted by a mortgage broker every day for a year before he finally took an "alternative" mortgage against his interests.[38] Recently we at CRL informally contacted a few practicing attorneys in North Carolina and asked them to provide examples of inappropriate or unaffordable loans from their cases. In less than 48 hours, we received a number of responses, including the cases briefly described in Appendix A. We also are aware of cases in which the borrower requested a fixed-rate mortgage, but received an ARM instead. The industry itself has asserted that borrowers placed in subprime hybrid ARMs could have received fixed-rate loans, and that the rate difference is "commonly in the 50 to 80 basis point range."[39] This rate bump is **less** than the increase in rates many borrowers are unknowingly charged by their mortgage brokers in order to provide a hefty yield-spread premium to the broker.

B. Loose Qualifying Standards and Business Practices

The negative impact of high-risk loans could be greatly reduced if subprime lenders had been carefully screening loan applicants to assess whether the proposed mortgages are affordable. Unfortunately, many subprime lenders have been routinely abdicating the responsibility of underwriting loans in any meaningful way.

Lenders today have a more precise ability than ever before to assess the risk of default on a loan. Lenders and mortgage insurers have long known that some home loans carry an inherently greater risk of foreclosure than others. However, by the industry's own admission, underwriting standards in the subprime market have become extremely loose in recent years, and analysts have cited this laxness as a key driver in foreclosures.[40] Let me describe some of the most common problems:

Not considering payment shock: Lenders who market 2/28s and other hybrid ARMs often do not consider whether the homeowner will be able to pay when the loan's interest rate resets, setting the borrower up for failure. Subprime lenders' public disclosures indicate that most are qualifying borrowers at or near the initial start rate, even when it is clear from the terms of the loan that the interest rate can (and in all likelihood, will) rise significantly, giving the borrower a higher monthly payment. For example, as shown in the chart below, publicly available information indicates that these prominent national subprime lenders do not adequately consider payment shock when underwriting ARMs:

Sample Underwriting Rules For Adjustable Rate Mortgages[41]

LENDER	UNDERWRITING RULE
OPTION ONE MORTGAGE CORP	Qualified at initial monthly payment.
FREMONT INVESTMENT & LOAN	Ability to repay based on initial payments due in the year of origination.
NEW CENTURY	Generally qualified at initial interest rate. Loans to borrowers with FICO scores under 580 and loan-to-value ratios of more than 80% are qualified at fully indexed rate minus 100 basis points.

These underwriting rules indicate that lenders routinely qualify borrowers for loans based on a low interest rate when the cost of the loan is bound to rise significantly—even if interest rates remain constant. In fact, it is not uncommon for 2/28 mortgages to be originated with an interest rate four percentage points under the fully-indexed rate. For a loan with an eight percent start rate, a four percentage point increase is tantamount to a 40 percent increase in the monthly principal and interest payment amount.

Failure to escrow: The failure to consider payment shock when underwriting is compounded by the failure to escrow property taxes and hazard insurance.[42] In stark contrast to the prime mortgage market, most subprime lenders make loans based on low monthly payments that do not escrow for taxes or insurance.[43] This deceptive practice gives the borrower the impression that the payment is affordable when, in fact, there are significant additional costs. Given that the typical practice in the subprime industry is to accept a loan if the borrower's debt is at or below 50 to 55 percent of their pre-tax income, using an artificially low monthly payment based on a teaser rate and no escrow for taxes and insurance virtually guarantees that a borrower will not have the residual income to absorb a significant increase whenever taxes or insurance come due during the first year or two, or certainly not when payments jump up after year two.

A recent study by the Home Ownership Preservation Initiative in Chicago found that for as many as one in seven low-income borrowers facing difficulty in managing their mortgage payments, the lack of escrow of tax and insurance payments were a contributing factor.[44] When homeowners are faced with large tax and insurance bills they cannot pay, the original lender or a subprime competitor can benefit by enticing the borrowers to refinance the loan and pay additional fees for their new loan. In contrast, it is common practice in the prime market to escrow taxes and insurance and to consider those costs when looking at debt-to-income and the borrower's ability to repay.[45]

Low/no documentation: Inadequate documentation also compromises a lender's ability to assess the true affordability of a loan. Fitch recently noted that "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector . . .."[46] "Low doc" and "no doc" loans originally were intended for use with the limited category of borrowers who are self-employed or whose incomes are otherwise legitimately not reported on a W-2 tax form, but lenders have increasingly used these loans to obscure violations of sound underwriting practices. For example, a review of a sample of these "stated-income" loans disclosed that 90 percent had inflated incomes compared to IRS documents, and "more disturbingly, almost 60 percent of the stated amounts were exaggerated by more than 50 percent."[47] It seems unlikely that all of these borrowers could not document their income, since most certainly receive W-2 tax forms, or that they would voluntarily choose to pay up to 1.5 percent higher interest rate to get the "benefit" of a stated-income loan.[48]

Multiple risks in one loan: In addition, regulators have expressed concern about combining multiple risk elements in one loan, stating that "risk-layering features in loans to subprime borrowers may significantly increase risks for both the…[lender] and the borrower."[49] Previously I described a brief overview of the increased risk associated with several subprime loan characteristics, including adjustable-rate mortgages, prepayment penalties, and limited documentation of income. Each of these items individually is associated with a significant increase in foreclosure risk, and each has been characteristic of subprime loans in recent years; combining them makes the risk of foreclosure even worse.

C. Broker Abuses and Perverse Incentives

Mortgage brokers are individuals or firms who find customers for lenders and assist with the loan process. Brokers provide a way for mortgage lenders to increase their business without incurring the expense involved with employing sales staff directly. Brokers also play a key role in today's mortgage market: According to the Mortgage Bankers Association, mortgage brokers now originate 45 percent of all mortgages, and 71 percent of subprime loans.[50]

Brokers often determine whether subprime borrowers receive a fair and helpful loan, or whether they end up with a product that is unsuitable and unaffordable. Unfortunately, given the way the current market operates, widespread abuses by mortgage brokers are inevitable.

First, unlike other similar professions, mortgage brokers have no fiduciary responsibility to the borrower who employs them. Professionals with fiduciary responsibility are obligated to act in the interests of their customers. Many other professionals already have affirmative obligations to their clients, including real estate agents, securities brokers and attorneys. Buying or refinancing a home is the biggest investment that most families ever make, and particularly in the subprime market, this transaction is often decisive in determining a family's future financial security. The broker has specialized market knowledge that the borrower lacks and relies on. Yet, in most states, mortgage brokers have no legal responsibility to refrain from selling inappropriate, unaffordable loans, or not to benefit personally at the expense of their borrowers.[51]

Second, the market, as it is structured today, gives brokers strong incentives to ignore the best interests of homeowners. Brokers and lenders are focused on feeding investor demand, regardless of how particular products affect individual homeowners. Moreover, because of the way they are compensated, brokers have strong incentives to sell excessively expensive loans. They earn money through up-front fees, not ongoing loan payments. To make matters worse for homeowners, brokers typically have a direct incentive to hike interest rates higher than warranted by the risk of loans. In the majority of subprime transactions, brokers demand a kickback from lenders (known as "yield spread premiums") if they deliver mortgages with rates higher than the lender would otherwise accept. Not all loans with yield-spread premiums are abusive, but because they have become so common, and because they are easy to hide or downplay in loan transactions, unscrupulous brokers can make excessive profits without adding any real value.

Experts on mortgage financing have long raised concerns about problems inherent in a market dominated by broker originations. For example, the chairman of the Federal Reserve Board, Ben S. Bernanke, recently noted that placing significant pricing discretion in the hands of financially motivated mortgage brokers in the sales of mortgage products can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws.[52] Similarly, a report issued by Harvard University's Joint Center for Housing Studies, stated, "Having no long term interest in the performance of the loan, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear."[53]

In summary: Mortgage brokers, who are responsible for originating over 70 percent of loans in the subprime market, have strong incentives to make abusive loans that harm consumers, and no one is stopping them. In recent years, brokers have flooded the subprime market with unaffordable mortgages, and they have priced these mortgages at their own discretion. Given the way brokers operate today, the odds of successful homeownership are stacked against families who get loans in the subprime market.

D. The Role of Investors

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

It is clear that mortgage investors have been a driving force behind the proliferation of abusive loans in the subprime market. Their high demand for these mortgages has encouraged lax underwriting and the marketing of unaffordable loans as lenders sought to fill up their coffers with risky loans. For example, approximately 80 percent of subprime mortgages included in securitizations issued the first nine months of 2006 had an adjustable-rate feature, the majority of which are 2/28s.[54]

It is particularly disturbing to note that not all of the investment support has come from private Wall Street firms. Even though Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSEs), have a mandate to help families achieve homeownership, and over the years have made a significant contribution , they have been purchasing a significant share of securities backed by highly questionable subprime loans—i.e., loans that were made without considering low- and moderate-income families' ability to repay. The GSEs bought about 25 percent of total subprime mortgage-backed securities sold in the first nine months of 2006.[55] This is an enormous investment in loans that are producing record-level foreclosures, and destroying the economic stability of African-American and Latino families.

It is disappointing that Fannie and Freddie have not shown leadership in this area, but instead have competed with other investors to buy securities backed by high-risk subprime loans that hurt consumers and reverse the benefits of homeownership. The GSEs, with their public mission, should not be permitted to purchase loans to distressed or minority or low-to-moderate income families that do not meet an "ability to repay" standard. Moreover, the GSEs should not receive credit from the Department of Housing and Urban Development to meet their affordable housing goals[56] for investing in loans that generate massive foreclosures and violate a majority of the GSEs' own published guidelines against predatory mortgage lending. These strong guidelines include, for example, standards on the ability to repay, the requirement of escrow accounts for taxes and insurance, and a prohibition on prepayment penalties. The GSEs apply these guidelines to loans purchased directly from loan originators, but not to the loans that they purchase as securities.

Further, by investing in loans that lack these basic protections, the GSEs not only contravene their mission, but they actually compound the disadvantages that minority borrowers face. This is because the loans subject to the predatory lending guidelines are prime, fixed-rate mortgages where white borrowers disproportionately receive their loans, while African-American and Latino families disproportionately receive their loans from the market where the GSEs have participated in without applying the guidelines.

Giving the GSEs HUD goals credit for these purchases defeats the very purpose for which the goals were set, namely to incent the GSEs to develop products and outreach that give borrowers less abusive products than those already available in the subprime marketplace. Rewarding the GSEs with goals credit for these purchases would be like giving banks credit under the Community Reinvestment Act for making abusive loans to low-wealth families. To be fair to the GSE's, however, HUD should remove these loans from both the numerator and the denominator of the overall mortgage market when calculating the percentage of the affordable housing market that the GSEs meet. Otherwise, if they stop purchasing the securities, and the loans are taken out of the numerator, it would likely be impossible for them to meet their percentage affordable housing goals, because subprime loans currently comprise such a large portion of the market.

Recently, as foreclosure rates have sharply increased, investors are looking more closely at underwriting practices that have produced foreclosure rates far higher than predicted, and in some instances have demanded the repurchase of loans that defaulted extremely quickly. In a few highly publicized cases, lenders have been forced out of business as a result.[57] However, defaults that occur after a designated three to six month period are not the responsibility of the lender. And while recent investor attention may force lenders to make some adjustments to accommodate investor concerns, it will not help those borrowers who are in 2/28s now, many of whom will lose their homes, their equity and their credit ratings when lenders foreclose on loans that never should have been made.

E. Federal Neglect

When Congress passed HOEPA in 1994, subprime loans made up only a very small share of the total mortgage market, and predatory lending practices were not nearly as prevalent as they were to become a few years later. It would have been helpful to update HOEPA to keep pace with the rashes of innovative predatory lending practices that occurred after the law passed, but with the pace of change in the mortgage market and the challenges of passing major legislation, that has not been—and never will be—feasible.

On the federal level, one regulatory agency was given explicit authority to take action: the Federal Reserve Board. The Board's primary authority comes through HOEPA, which provides the Board with broad authority to prohibit unfair or deceptive mortgage lending practices and to address abusive refinancing practices. Specifically, the Act includes these provisions:

> (l) DISCRETIONARY REGULATORY AUTHORITY OF BOARD.--
> (2) PROHIBITIONS.--The Board, by regulation or order, shall prohibit acts or practices in connection with--
> (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and
> (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.[58]

While HOEPA generally applies to a narrow class of mortgage loans, it is important to note that Congress granted the authority cited above to the Board for <u>all</u> mortgage loans, not only loans governed by HOEPA (closed end refinance transactions) that meet the definition of "high cost." Each of the substantive limitations that HOEPA imposes refer specifically to high-cost mortgages.[59] By contrast, the discretionary authority granted by subsection (l) refers to "mortgage loans" generally.[60]

The legislative history makes clear that the Board's discretionary authority holds for all mortgage loans. The HOEPA bill that passed the Senate on March 17, 1994, and the accompanying Senate report, limited the Board's authority to prohibit abusive practices in connection with high-cost mortgages alone.[61] However, this bill was amended so that the bill that ultimately passed both chambers, as cited above, removed the high-cost-only limitation, and the Conference Report similarly removed this restriction.[62] The Conference Report also urged the Board to protect consumers, particularly refinance mortgage borrowers.[63]

The Board has been derelict in the duty to address predatory lending practices. In spite of the rampant abuses in the subprime market and all the damage imposed on consumers by predatory lending—billions of dollars in lost wealth—the Board has never implemented a single discretionary rule under HOEPA outside of the high cost context. To put it bluntly, the Board has simply not done its job.

III. Solutions

Congress has a long, proud history of strong policies to support homeownership, but that task has become more complicated than ever. Supporting homeownership continues to involve encouraging fair lending and fair access to loans. But supporting homeownership also means refusing to support loans that are abusive, destructive and unnecessarily risky.

A few years ago, the problem of subprime foreclosures likely would have received scant attention from policymakers, since subprime mortgages represented only a small fraction of the total mortgage market. Today subprime mortgages comprise almost one quarter of all mortgage originations. The merits of this expanding market are widely debated, but one point is clear: Subprime mortgage credit—and the accompanying foreclosures—have become a major force in determining how and whether many American families will attain sustainable wealth.

There are simple, known solutions to help preserve the traditional benefits of homeownership and to address many of the problems I have mentioned today. Here I reiterate our five recommendations:

1. Restore safety to the subprime market by imposing a borrower "ability to repay" standard for all subprime loans. The recently-issued Guidance on nontraditional mortgage products should apply to all subprime hybrid ARM loans and non-traditional products. Specifically, the agencies should affirm that this Guidance covers the most widely destructive type of loan today: 2/28s in the subprime market. We also recommend that they include the requirement that lenders escrow for property taxes and hazard insurance on subprime loans, and include these payments in the calculation of the borrower's ability to repay the loan. Further, the Guidance points out the problems with no-doc loans, and should affirmatively require that lenders verify and document all sources of income using either tax or payroll records, bank account statements or other reasonable third-party verification.

2. Require mortgage brokers to have a fiduciary duty to their clients. We know it is both feasible and desirable to require mortgage brokers to serve the best interests of the people who pay them. Brokers manage the most important transaction most families ever make. Their role is at least as important as that of stock brokers, lawyers and Realtors—professions that already have fiduciary standards in place.

3. Require the Federal Reserve to act, or address abuses through the FTC. HOEPA, the major federal law designed to protect consumers against predatory mortgage lending, has manifestly failed to stem the explosion of harmful lending abuses that has accompanied the recent subprime lending boom. Congress has provided the Federal Reserve Board with discretionary authority to address these problems for all mortgage loans, but to date the Board has not taken advantage of this authority. Given the Board's record, Congress should seriously consider enlisting the Federal Trade Commission's assistance in addressing abuses that have gone on too long.

4. Require government-sponsored enterprises to stop investing in abusive subprime loan securities. Currently Fannie Mae and Freddie Mac are purchasing mortgage-backed securities that include high-risk subprime loans. By doing so, they are essentially supporting and condoning lenders who market abusive, high-risk loans that are not truly affordable. This is clearly counter to the mission of those agencies. They should voluntarily stop investing in these securities. In addition, HUD should stop giving them affordable goals credit for purchasing these AAA securities (take them out of both the numerator and denominator in assessing the market), and Ofheo should prohibit the agencies from adding these securities to their portfolios.

5. Strengthen protections against destructive home lending by passing a new national anti-predatory lending bill. Federal law has clearly not kept up with the abuses in the changing mortgage market. HOEPA needs to be extended and updated to address the issues that are driving foreclosures today. Even should this happen, we need to realize that it is impossible for any single law to cover all contingencies or to anticipate predatory practices that will emerge in the future. Any new federal law must therefore preserve the right of the states to supplement the law, when necessary, to address new or locally-focused lending issues. While HOEPA is weak, it did recognize the limits of federal law, and therefore functions as a floor, not a ceiling. If HOEPA had not allowed states to take action, today's disastrous levels of foreclosures would be even worse.

Thank you very much for the opportunity to testify before you today. I would be happy to answer any questions you may have.

APPENDIX A

To illustrate the unfortunate realities of inappropriate and unaffordable 2/28 adjustable rate mortgages (ARMs), recently the North Carolina Justice Center informally contacted a few practicing attorneys in North Carolina to provide examples from their cases. They received a number of responses, including these described below.

1. **From affordable loan to escalating ARM .**
   Through a local affordable housing program, a homeowner had a 7% fixed-rate, 30-year mortgage. A mortgage broker told the homeowner he could get a new loan at a rate "a lot" lower. Broker originated a 2/28 ARM with a starting rate of 6.75%, but told borrower that it was a fixed-rate, 30-year mortgage. At the 24^{th} month, the loan went up to 9.75%, following the loan's formula of LIBOR plus 5.125% and a first-change cap maximum of 9.75%. Loan can go up to a maximum of one point every six months, with a 12.75% total cap. Now borrower cannot afford the loan and faces foreclosure.

2. **Temporary lower payments—a prelude to shock.**
   Homeowner refinanced out of a fixed-rate mortgage because she wanted a lower monthly payment. The homeowner expressly requested lower monthly payments that included escrow for insurance and taxes. Mortgage broker assured her that he would abide by her wishes. Borrower ended up in a $72,000 2/28 ARM loan with first two years monthly payments of $560.00 at a rate of 8.625%. This initial payment was lower than her fixed-rate mortgage, but it did not include escrowed insurance and taxes. After two years, loan payments increased every six months at a maximum one percent with a cap of 14.625%. At the time of foreclosure, the interest rate had climbed to 13.375% with a monthly payment $808.75. If the loan had reached its maximum interest rate, the estimated monthly payment would be close to $900.00.

3. **Unaffordable from the start.**
   Homeowner had a monthly payment of $625 and sought help from a mortgage broker to lower monthly payment. Broker initially said he could lower the payment, but before closing said the best he could do was roughly $800. He assured borrower that he could refinance her to a loan with a better payment in six months. Previously he had advised homeowner not to pay her current mortgage payment because the new loan would close before the next payment due date. In fact, closing occurred after the payment was due, and borrower felt she had to close. Loan was a 2/28 ARM with an initial interest rate of 11% and a ceiling of 18% at an initial monthly payment of $921. Interest at first change date is calculated at LIBOR plus 7%, with a 12.5% cap and a 1.5% allowable increase/decrease at each 6-month change date. First change date is June 1, 2008. By approximately the third payment, however, borrower could not afford mortgage payments and is now in default.

APPENDIX B

February 5, 2007

The Honorable Christopher Dodd
448 Russell Senate Office Building
United States Senate
Washington, D.C. 20510-0702

The Honorable Jack Reed
728 Hart Senate Office Building
United States Senate
Washington, D.C. 20510- 3903

The Honorable Wayne Allard
521 Dirksen Senate Office Building
United States Senate
Washington, D.C. 20510-0605

The Honorable Jim Bunning
316 Hart Senate Office Building
United States Senate
Washington, D.C. 20510-1703

The Honorable Charles Schumer
313 Hart Senate Office Building
United States Senate
Washington, D.C. 20510-3203

Dear Senators,

On January 2nd, the Consumer Mortgage Coalition (CMC) wrote a letter to Senators Sarbanes, Allard, Dodd, Bunning, Reed, and Schumer arguing that it would be inappropriate to apply the October 4th Interagency Guidance on Nontraditional Mortgage Product Risks to subprime 2-28 ARM loans. On January 25th, the Coalition for Fair & Affordable Lending (CFAL) wrote a letter to similar effect to the heads of the federal banking regulators. Their arguments are similar in many respects, and, we respectfully submit, both are equally without merit. Subprime 2-28 mortgages (and other hybrid ARMs with similar characteristics such as subprime 3-27 mortgages) present the full array of risks that drove regulators to issue the Guidance, and should be covered. We address CMC's arguments below, and then, to the extent CFAL has raised any further points meriting response, we address those briefly as well.

Although the CMC tries to link 2-28 subprime ARMs to more established prime hybrid ARMs, the reality remains that 2-28 subprime ARMs present a radically different risk to borrowers and can be covered under the Guidance without introducing new standards on lower-risk prime ARMs. Indeed, the most recent Mortgage Bankers Association *National Delinquency Survey* found that subprime ARMs are starting foreclosure at more than seven times the rate of prime ARMs in the third quarter of 2006.[1]

Many subprime lenders still find such lending profitable, however, because of two factors. First, the advent of risk-based pricing allows them to offset even high rates of

[1] Mortgage Bankers Association, *National Delinquency Survey*, *Third Quarter 2006*, (Sept. 30, 2006).

predicted foreclosures by adding increased interest costs. Second, the ability to securitize mortgages and transfer credit risk to investors has largely removed the risk of volatile upswings in foreclosures from lenders. In other words, high foreclosure rates have simply become a cost of business that is passed onto borrowers and, sometimes, investors.

One of the primary purposes of the Guidance is to protect borrowers against payment shock. 2-28s almost invariably entail a substantial payment shock because of the way they are designed, underwritten and marketed today. Typical practice in the subprime industry is to accept a loan if the borrower's debt is at or below 50 to 55% of pre-tax income, using an artificially low monthly payment based on a teaser rate and no escrow for taxes and insurance. This virtually guarantees that a borrower will not have the residual income to absorb a significant increase whenever taxes or insurance come due during the first year or two, or when the teaser rate resets.

The harm inflicted by these loans impacts even more borrowers than those affected by the non-traditional mortgages because, first, of the explosion in the subprime market -- from 1994 to 2005, it grew from $35 billion to $665 billion, and from 1998 to 2006, the subprime share of total mortgage originations climbed from 10 percent to 23 percent.[2] The second reason is that 2-28s are by far the most common product in the subprime market today;[3] through the second quarter of 2006, hybrid ARMs made up 81 percent of the subprime loans that were packaged as investment securities.[4]

Moreover, 2-28s and 3-27s are having a particularly damaging impact on communities of color. According to the most recent HMDA data, a majority of loans to African-American borrowers were so-called "higher-rate" loans,[5] while four in ten loans to Latino[6] borrowers were higher-rate, the substantial portion of which are 2-28s and 3-27s. By contrast, approximately 80% of home loans during this time period to white families were conventional loans, the sector clearly protected by the Guidance.[7]

We have seen that borrowers with subprime ARMs were almost never given a choice of products, but were instead automatically steered to an ARM and were given little or no explanation of the ARM's terms. These borrowers should have the same right to receive

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[2] Subprime Mortgage Origination Indicators, Inside B&C Lending (November 10, 2006).
[3] Hybrid ARMs and hybrid interest-only ARMs have become "the main staples of the subprime sector ." *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).
[4] *See* Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs, p. 4; Lehman Brothers, *Cause for Al-ARM – A Comprehensive Tool for Understanding the Recent Development of the Adjustable Rate Mortgage and Determining the Implications on Credit Risk of its Growing Popularity*, (June 15, 2005) at 9.
[5] 54.7 percent of African-Americans who purchased homes in 2005 received higher-rate loans. 49.3 percent received such loans to refinance their homes.
[6] 46.1 percent of Latino white borrowers received higher-rate purchase loans. 33.8 percent received higher-rate refinance loans. For the purpose of this comment, "Latino" refers to borrowers who were identified as racially white and of Latino ethnicity.
[7] *See e.g.*, Debbie Gruenstein Bocian, *Center for Responsible Lending Comment on Federal Reserve Analysis of Home Mortgage Disclosure Act Data* (September 28, 2006).

"information that is designed to help them make informed decisions when selecting and using these products" as recommended by the Guidance.

CMC & CFAL Assertions Answered

ASSERTION: 2-28 subprime ARMs are "well-established" with "default rates that are comparable to or sometimes better than those on 30-year fixed rate loans."

ANSWER: The first-lien subprime market is less than a decade old and is only now being tested for the first time as waning house price appreciation exposes weaknesses that are projected to lead to 1 in 5 subprime loans ending in foreclosure.[8]

EVIDENCE:

- Using housing price forecasts from Moody's Economy.com, a recent Center for Responsible Lending report, *Losing Ground*, projected that 1 in 5 (19.4%) of subprime loans originated in 2006 will end in foreclosure and that subprime ARM loans have a greater risk of foreclosure than subprime fixed-rate loans.[9] For example, the report found that subprime ARM loans originated in 2002 had a 78% greater risk of foreclosure than subprime fixed-rate loans after controlling for credit score.
- Multivariate regression analysis from the University of North Carolina showed that subprime ARMs had a 49% greater risk of foreclosure than subprime fixed-rate mortgages after controlling for FICO score, loan-to-value ratio, strength of income documentation, and economic conditions.[10]
- According to the Mortgage Bankers Association National Delinquency Survey, subprime ARMs have much higher delinquency rates than prime ARMs and subprime fixed rate loans. The 2006 third quarter data showed that the delinquency rate for subprime ARMs was 13.22 percent, compared to 9.59 percent for subprime fixed rate loans and just 3.06 percent for prime ARMs.[11]

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[8] Center For Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* (Dec. 2006) at 3-5, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189.

[9] We have been pleased to receive informal confirmation of our projections from various sources, including major investment firms. The attached Baltimore Sun article provides a good summary of the paper's findings and perspective from multiple market participants.

[10] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures:The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, University of North Carolina at Chapel Hill (January 25, 2005) at 28-9.

[11] Mortgage Bankers Association, *National Delinquency Survey,Third Quarter 2006*, (Sept. 30, 2006) at 7, 9.

ASSERTION: "[If the Guidance were extended to 2/28 mortgages, [m]any first-time borrowers would lose the opportunity to own a home."

ANSWER: Loans that borrowers cannot afford do not lead to lasting homeownership opportunities. Moreover, the loans in the subprime market are typically debt consolidation refinance loans and do not create new homeownership opportunities.

EVIDENCE:

- Assessing subprime lending from 1998-2004, CRL reports in *Losing Ground* that refinance loans were a majority of all subprime originations.[12]
- A survey published in *Housing Policy Debate* in 2004 by staff from Opinion Research Corporation, Freddie Mac, and Equitec revealed that only 14.2% of subprime borrowers reported taking their loan to purchase a first home.[13] Further, with projected default rates of 19.4% for recent subprime loans, subprime lending appears to be on pace to result in a net loss in homeownership in its current form. Finally, most of the borrowers in a cohort of subprime loans refinance into further subprime loans, and many of these will also be foreclosed upon; following the borrower through subsequent loans rather than just looking at that first loan cohort, CRL roughly estimates in *Losing Ground* actual subprime borrower foreclosure rates over 35%.

ASSERTION: "The type of deep discount below the fully-indexed rate that Mr. Calhoun [of CRL] addressed in his testimony is not common." (Referencing testimony before the Senate Banking Committee regarding Nontraditional Mortgages on September 20, 2006)

ANSWER: High payment shock is absolutely typical of 2-28 subprime ARMs.

EVIDENCE:

- A December 11, 2006 presentation by Fannie Mae Chief Economist David Berson at the Office of Thrift Supervision reported that 2006 subprime ARM loans in mortgage-backed securities carried an average initial interest rate of 7.95% and an average fully-indexed rate of 11.29% as of year-end (margins averaged 5.93% over 6-month USD LIBOR)[14]. For a 2-28 subprime ARM this differential represents a payment shock of 32% between the initial rate and the fully-indexed rate.
- A mid-year 2006 analysis from Fitch Ratings similarly reported that 2-28 subprime ARMs carried a built-in payment shock of 29% even if interest rates

[12] Center For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners (Dec. 2006) at 3-5, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189 at 46.
[13] Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency", Housing Policy Debate 15:3 (2004).
[14] David Berson, VP & Chief Economist at Fannie Mae, *Challenges and Emerging Risks in the Home Mortgage Business*, presented at the National Housing Forum at the Office of Thrift Supervision (December 11, 2006).

remain unchanged, with LIBOR remaining at 4.27%. With year-end LIBOR at 5.36%, the Fitch analysis suggests payment shocks of 48%.[15]

ASSERTION: "We note that both of these features [subprime prepayment penalties and low-documentation loans] can benefit borrowers…. Lenders are able to offer low-documentation loans because the technology of predicting loan performance has improved..."

ANSWER: Both of these features are associated with higher foreclosure risk on subprime loans and should certainly be scrutinized in the context of the Guidance. Limited documentation loans often are used to make loans where it is known that the borrower's income is insufficient to cover the scheduled payments.

EVIDENCE:

- UNC researchers found that prepayment penalties and limited documentation loans in subprime loans nationally were features associated with a 16-20% and a 15% increase in foreclosure risk, respectively, after controlling for credit score, loan-to-value ratio, economic conditions, and several other variables.[16]
- The CRL *Losing Ground* report finds that prepayment penalties and limited documentation on subprime loans nationally were associated with increased foreclosure risk. For example, for loans originated in 2001, controlling for credit score, the increased foreclosure risk for prepayment penalties and limited documentation features on subprime loans were 36% and 26% respectively.[17]
- Similarly, on a set of subprime loans from the Chicago area, OCC researcher Morgan Rose reported that subprime loans with prepayment penalties and low-income documentation were more likely to lead to a foreclosure starts for subprime refinance ARM loans.[18]
- A report from the Mortgage Asset Research Institute (MARI) examined a sample of stated-income loans and found that 90 percent of borrowers had incomes higher than those found in IRS files and "more disturbingly, almost 60 percent of the

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[15] Structured Finance: U.S. RMBS Criteria for Subprime Interest-Only ARMs , FITCH RATINGS CREDIT POLICY (New York, N.Y), October 4, 2006.
[16] Roberto G. Quercia, Michael A. Stegman and Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures:The Special Case of Prepayment Penalties and Balloon Payments*, Center for Community Capitalism, University of North Carolina at Chapel Hill (January 25, 2005)
[17] Center For Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners (Dec. 2006) at 3-5, available at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189 at 22.
[18] Morgan Rose, OCC Working Paper #2006-1, "Foreclosures of Subprime Mortgages in Chicago: Analyzing the Role of Predatory Lending Practices."

stated income amounts were exaggerated by more than 50 percent."[19] Similarly, a survey of 2,140 mortgage brokers (constituting a national sample) found that 43 percent of brokers who use low documentation loan products know that their borrowers "can't qualify under standard [debt-to-income] ratios" because they did not have enough income for the loan.[20]

ASSERTION: "Investors set limits on the extent to which loan underwriting can take this initial "teaser" rate into account. They sometimes … [require] that loans with an aggressive initial discount be underwritten at the fully-indexed rate."

ANSWER: To protect both borrowers and responsible lenders who require underwriting at the fully indexed rate, it is important that regulators level the playing field by making this standard applicable to all 2-28 subprime ARMs. It is clear that major subprime lenders do not underwrite to the fully-indexed rate.

EVIDENCE:

- A 2005 Option One prospectus shows that the lender underwrote loans to the lesser of one percentage point over the start rate or the fully-indexed rate.[21] Yet, under this "lesser of" formulation, the latter would typically never apply to 2-28 subprime ARMs.
- As summarized in a November 2006 release, New Century's strongest underwriting practice, which is applied only to borrowers with a credit score under 580 and a loan-to-value ratio over 80 percent, is to evaluate the borrower's ability to repay the mortgage at an interest rate equal to the fully indexed rate minus one percentage point. Other borrowers have their ability to repay screened at the initial interest rate.[22]

Additional Assertions By CFAL Answered

ASSERTION: The Guidance "does not take into account an individual's income growth over the years."

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[19] Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006).

[20] "How Mortgage Brokers View the Booming Alt A Market," survey conducted by Campbell Communications cited in Inside Mortgage Finance, Volume 23, Number 42 (November 3, 2006 available at http://www.imfpubs.com/issues/imfpubs_imf/23_42/news/1000004789-1.html and cited in Harney, Kenneth, *"The Lowdown on Low-Doc Loans,"* The Washington Post 11/25/2006 page F-1 (November 25, 2006), available at http://www.washingtonpost.com/wp-dyn/content/article/2006/11/24/AR2006112400503_pf.html

[21] *See* Option One Prospectus, Option One MTG LN TR ASSET BK SER 2005 2 424B5 May 3 2005, S.E.C. Filing 05794712 at S-50.

[22] *See Adoption of Additional Lending Best Practices,* included in "New Century Financial Corporation Reports Third Quarter 2006 Results and Provides Outlook for 2007," (November 2, 2006) *available at* http://news.moneycentral.msn.com/ticker/article.aspx?Symbol=US:NEW&Feed=PR&Date=20061102&ID=6163344.

ANSWER: Subprime lenders' public filings make clear that the lenders do not consider whether the borrower is likely to experience any income growth whatever, but rather qualify the borrower with a focus on the initial years of payment.[23] In the vast majority of cases, the lenders have no reasonable basis for assuming that the borrowers receiving subprime 2-28s and 3-27s will experience any increase in income.

ASSERTION: The Guidance "does not appear to recognize that market forces, including secondary market purchasers' requirements, generally do a better job than regulators at managing nontraditional risks."

ANSWER: This proposition is negated by industry leaders' own statements. Consider the frank acknowledgement by the chief executive of Ownit Mortgage Solutions, William D. Dallas, who "acknowledges that [underwriting] standards were lowered, but he placed the blame at the feet of investors and Wall Street saying they encouraged Ownit and other supbrime lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. 'The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans,' he said. 'What would you do?'"[24]

ASSERTION: "Traditional hybrid ARMs offer a significantly lower monthly payment for the initial fixed–rate period than an equivalent traditional fixed-rate loan. The rate difference is commonly in the 50 to 80 basis point range."

ANSWER: This assertion reveals a great tragedy confronting many of the families currently losing their homes in foreclosure: for an additional 50 – 80 basis points at the outset, they could have been holding sustainable 30-year fixed rate loans. Gaining little more than a 50 basis point short-term discount, borrowers are being lured into loans that will increase by up to 3% at the beginning of the 25th month, cost them substantial equity stripped through refinancing costs and fees, or force them to lose their home altogether.

Compare the fixed rate cost with the 50 – 100 basis point bump up that roughly half of borrowers pay for not documenting their income, even though most are employees fully able to provide W-2's. Or compare it with the extra interest borrowers pay to give their mortgage brokers, who originate 71% of subprime loans,[25] a yield-spread premium/kickback. For example, for brokers who increase a borrower's interest rate beyond what they qualify for by an extra 1.25%, a recent New Century rate sheet rewards the broker with 2% of the loan amount as a yield-spread premium.

ASSERTION: "The traditional hybrid ARM structure is especially well suited to the needs of nonprime consumers who are looking for a more affordable transitional product as they reestablish their credit and financial footing."

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[23] *See* discussion of Option One and New Century underwriting standards, above.
[24] 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.
[25] MBA Research Data Notes, "Residential Mortgage Origination Channels," September 2006.

ANSWER: This observation relates to the hybrid ARMs in the prime market, where the introductory rate typically lasts at least 5 years, where lenders escrow for taxes and insurance, and where borrowers are not subject to prepayment penalties. It is directly contrary to the facts associated with subprime 2-28 and 3-27 loans, as shown in the data discussed above.

ASSERTION: "[Pre-payment] penalties, in fact, generally terminate automatically when the loan adjusts to the fully-indexed rate. This allows most consumers to achieve a substantial savings through two or three years of the lower rate, rebuild their credit and then to move promptly to a new lower rate loan without incurring a penalty or having to pay the higher adjusted rates for any extended period."

ANSWER: The experience of most 2-28 and 3-27 borrowers is contary to the circumstances alleged by CFAL. As CFAL acknowledges, the loans are designed so that the pre-payment penalty remains in effect until the time that the rate resets. This means that the borrower can almost *never* avoid both the pre-payment penalty and the increased rate. As described above, these loans are typically underwritten to so that a substantial proportion of 2-28 and 3-27 borrowers predictably will not be able to afford the loan when the rate resets, and so must choose between paying the penalty and defaulting when the payment shock hits. The latter most definitely does not improve the borrower's credit rating and increases the pressure on the borrower to refinance on the lender's terms.

ASSERTION: "[F]oreclosures for nonprime loans, including hybrid ARMs, are dramatically less than the grossly inaccurate 20% rate ('1 in 5' loans) that some consumer groups have been claiming. Industry data indicate, for example, that the foreclosure inventory rate during the third quarter of 2006 for subprime loans was about 3.9% and the percent of new nonprime loan foreclosures was around 1.8%"

ANSWER: The CFAL figure is misleading in that it represents reflects the percentage of outstanding loans that are in foreclosure at a specific point in time, while the 20% rate is a cumulative rate that reflects the perecentage of loans originated during a year that will eventually end in foreclosure over time. Further, the 20% anticipated foreclosure rate on subprime 2-28 loans is in fact a conservative estimate based on conservative assumptions applied to objective loan-level data, and corresponds to data compiled from industry sources, as detailed in our *Losing Ground* report, described above. In fact, the numbers are hardly inconsistent. If 1.8% of subprime loans foreclose each quarter over three years, that would be 21.6% cumulative foreclosure starts. And the 20% number increases substantially when one tracks the subprime borrower through subsequent subprime refinancings, each of which has its own risk of foreclosure.

Conclusion

The steep payment shocks on 2-28 subprime ARMs that follow from dramatic scheduled increases in the interest charges just two years into the loan represent precisely the sort of "deferral of interest" on loans to "a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgages" addressed by the Guidance. In the case of 2-28 subprime ARMs, the change in interest rates is typically so large at year two that they may properly be characterized as a contingent deferral of interest from early years to later years of the loan term.[26] The magnitude of this deferral is significantly larger than typically found in prime ARM loans.

Federal Reserve Board Governor Susan Bies reached a similar conclusion, recently stating, "Let's face it; a teaser loan really is a negative [amortization] loan because you don't pay interest up front."[27] In addition to being consistent with the notion that these subprime hybrid ARMs present a deferral of interest, this quote also illustrates a second dimension on which subprime ARMs tend to differ from their prime counterparts. Specifically, low introductory rates on subprime ARMs are typically associated with high up-front financed fees whereas fees on prime ARMs tend to be much lower.[28] In other words, subprime ARMs routinely find borrowers trading equity in exchange for dramatically lower interest payments—thereby producing the same result as negative amortization.

In addition, this deferral of interest is being presented to borrowers with weaker credit histories who have not traditionally been faced with such large payment shocks. For these reasons, it remains critical that regulators clarify that the Guidance applies to 2-28 and 3-27 subprime ARMs.[29]

We recognize that this issue is emblematic of the widespread abuses in the mortgage market that require Congressional action. We look forward to working with you all on a response to these problems.

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[26] The contingent nature of the deferral (borrowers have to stay in the loan until adjustment to experience its effects) are much like the contingent nature of the deferral of interest in payment option ARMs (where borrowers only feel the effects if they pay less than the full amount of interest due). In either case, the Guidance should require that lenders underwrite the loan to standards that ensure the borrower can payoff the loan should these contingencies occur.

[27] Richard Cowden, *Bies Says Regulators to Consider Principles, Not Products, if They Revise Loan Guidance*, BNA Banking Report, vol. 88 no. 02 (Jan. 15, 2007) at 56.

[28] Freddie Mac reports that the most common prime hybrid ARM (5/1 ARMs), had an average initial discount rate of 1.76 percentage points and fees and points amounting to 0.5% of the loan amount. *Freddie Mac Releases Results of its 23rd Annual ARM Survey*, Freddie Mac (January 3, 200) available at http://www.freddiemac.com/news/archives/rates/2007/20070103_06armsurvey.html. An article detailing a survey of borrowers reported that subprime borrowers paid higher fees than prime borrowers. Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 15 Housing Policy Debate 3, pp571533 (2004).

[29] While some have pointed to a reference in footnote 1 in the guidance as evidence that these loans should not be included, that footnote does not clearly address 2-28 subprime ARMs. In it, the regulators explicitly exclude "fully amortizing residential mortgage loan products." However, in the Appendix to the Guidance they also make clear that "fully amortizing" refers both to principal and interest. They use an example where they specifically qualify the term as follows: "a fully amortizing principal and interest payment."

Sincerely,

Center for Responsible Lending
National Consumer Law Center
Consumer Federation of America
Consumer Action
National Lawyers Committee for Civil Rights Under the Law
Rainbow Push
Opportunity Finance Network
U.S. PIRG
National Community Reinvestment Coalition
National Association for the Advancement of Colored People
Acorn
NACA

CC:

The Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation
The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System
The Honorable John C. Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency
The Honorable JoAnn Johnson, Chairman, National Credit Union Administration
The Honorable Neil Milner, President and CEO, Conference of State Banking Supervisors
The Honorable John M. Reich, Director, Office of Thrift Supervision

End Notes

[1] Our research finds that one out of every five (19 percent) subprime loans made in recent years will fail. This rate is far worse than the ten-year default rate (14.9%) arising from the "Oil Patch" disaster of the 1980s. See Ellen Schloemer, Keith Ernst, Wei Li and Kathleen Keest, "Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners," December 2006 available at www.responsiblelending.org, note 18.

[2] Inside B&C Lending (Sept. 1, 2006); *see* also INSIDE MORTGAGE FINANCE MBS DATABASE, 2006.

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

[4] *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).

[5] *See* 71 Fed. Reg. 58609 (October 4, 2006) for the federal Interagency Guidance on Nontraditional Mortgage Product Risks, issued by the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Department of the Treasury and the National Credit Union Administration. The Conference of State Banking Supervisors and the American Association of Residential Mortgage Regulators (AARMR) followed suit by issuing draft model guidance for state regulators, which has been implemented in at least 20 states. For a summary of state issuances, *see* http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/FederalAgencyGuidanceDatabase/State_Implementation.htm.

[6] Much of the following material originally appeared in the "Losing Ground" report, cited in note 1.

[7] Ira Goldstein, *Bringing Subprime Mortgages to Market and the Effects on Lower-Income Borrowers*, p.2 Joint Center for Housing Studies, Harvard University (February 2004) at http://www.jchs.harvard.edu/publications/finance/babc/babc_04-7.pdf.

[8] 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). For most types of subprime loans, African-Americans and Latino borrowers are more likely to be given a higher- cost loan even after controlling for legitimate risk factors. Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending, (May 31, 2006) at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=29371010; S*ee also* Darryl E. Getter, *Consumer Credit Risk and Pricing*, Journal of Consumer Affairs (June 22, 2006); Howard Lax, Michael Manti, Paul Raca, Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 533, 562, 569, Housing Policy Debate 15(3) (2004).

[9] *Subprime Mortgage Origination Indicators*, Inside B&C Lending (November 10, 2006).

[10] *See, e.g.*, Eric Stein, *Quantifying the Economic Costs of Predatory Lending*, Center for Responsible Lending (2001).

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

[12] *See, e.g.* David W. Berson, *Challenges and Emerging Risks in the Home Mortgage Business*: *Characteristics of Loans Backing Private Label Subprime ABS*, Presentation at the National Housing Forum, Office of Thrift Supervision (December 11, 2006).

[13] The rate of new foreclosures as a percent of all loans rose from 0.13 in 1980 to 0.42 in 2005, as reported in the *National Delinquency Survey*, Mortgage Bankers Association. 2005 new foreclosure filings statistic from Realty Trac in *Home Foreclosures on the Rise*, MoneyNews (February 23, 2006) at http://www.newsmax.com/archives/articles/2006/2/23/134928.shtml.

[14] National Foreclosures Increase 17 Percent In Third Quarter, Realty Trac (November 1, 2006) at http://www.realtytrac.com/ContentManagement/PressRelease.aspx?ItemID=1362

[15] *See, e.g.*, Saskia Scholtes, Michael Mackenzie and David Wighton, *US Subprime Loans Face Trouble*, Financial Times (December 7, 2006); *Nightmare Mortgages*, Business Week (September 11, 2006).

[16] Geoff Smith, *Key Trends in Chicago Area Mortgage Lending: Analysis of Data from the 2004 Chicago Area Community Lending Fact Book*, Woodstock Institute (March 2006) available on the Woodstock Institute website.

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

[18] Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," p. 57, 69, 72, 75 *Housing Policy Debate* (17:1) Fannie Mae Foundation (2006).

[19] The Home Mortgage Disclosure Act requires most lenders to file annual reports containing specified information about the "higher-cost loans" they originated. "Higher-cost loans" are those for which the APR exceeds the rate on a Treasury security of comparable maturity by 3 percentage points for first liens, and 5 percentage points for second liens. FRB analysis of 2005 HMDA data indicates that non-Hispanic whites received over 1.2 million higher-cost loans, compared to 388,471 for African-Americans and 375,889 for Latinos. Authors' calculations from data reported in Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data*, Federal Reserve Bulletin A123, A160-161 (Sept. 8, 2006), at http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf.

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

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

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

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

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

[25] *See Structured Finance*, note 21.

[26] *See Structured Finance*, note 21.

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

[28] *See Structured Finance*, note 21.

[29] Freddie Mac reports that the most common prime hybrid ARM (5/1 ARMs), had an average initial discount rate of 1.76 percentage points and fees and points amounting to 0.5% of the loan amount. *Freddie Mac Releases Results of its 23rd Annual ARM Survey*, Freddie Mac (January 3, 200) available at http://www.freddiemac.com/news/archives/rates/2007/20070103_06armsurvey.html. An article detailing a survey of borrowers reported that subprime borrowers paid higher fees than prime borrowers. Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, *Subprime Lending: An Investigation of Economic Efficiency*, 15 Housing Policy Debate 3, pp571533 (2004).

[30] *See* Interagency Guidance on Nontraditional Mortgage Product Risks at p. 9.

[31] The contingent nature of the deferral (borrowers have to stay in the loan until adjustment to experience its effects) are much like the contingent nature of the deferral of interest in payment option ARMs (where borrowers only feel the effects if they pay less than the full amount of interest due). In either case, the Interagency Guidance should require that lenders underwrite the loan to standards that ensure the borrower can payoff the loan should these contingencies occur.

[32] Richard Cowden, *Bies Says Regulators to Consider Principles, Not Products, if They Revise Loan Guidance*, BNA Banking Report, vol. 88 no. 02 (Jan. 15, 2007) at 56.

[33] Joe Adler, *In Brief: FDIC May Treat 2/28s Like Other Exotics*, American Banker, vol 171, no. 220 (November 15, 2006); Patrick Rucker, *U.S. bank regulators eye new mortgage guidance* (January 10, 2007).

[34] *See* David W. Berson, *Challenges and Emerging Risks in the Home Mortgage Business*: *Characteristics of Loans Backing Private Label Subprime ABS*, Presentation at the National Housing Forum, Office of Thrift Supervision (December 11, 2006).

[35] January 29, 2006 letter from CRL to North Carolina Office of the Commissioner of Banks, at 11. Available at CRL's website at http://responsiblelending.org/policy/regulators/.

[36] December 7, 2006 letter from U.S. Senators Paul S. Sarbanes, Wayne Allard, Christopher J. Dodd, Jim Bunning, Jack Reed, and Charles Schumer to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 2.

[37] 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.

[38] Kirstin Downey, "Mortgage-Trapped: Homeowners with New Exotic Loans Aren't Always Aware of the Risk Involved," Washington Post (January 14, 2007).

[39] 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.

[40] *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).

[41] *See* Option One Prospectus, Option One Mortgage Loan Trust 2006-3 424B5 (October 19, 2006) available at: http://www.sec.gov/Archives/edgar/data/1378102/000088237706003670/d581063_424b5.htm; Fremont Investment and Loan Prospectus, Fremont Home Loan Trust 2006-1 424B5 (April 4, 2006) available at: http://www.sec.gov/Archives/edgar/data/1357374/000088237706001254/d486451_all.htm **;** Morgan Stanley Prospectus, Morgan Stanley ABS Capital I Inc. Trust 2007-NC1 Free Writing Prospectus (January 19, 2007) available at: http://www.sec.gov/Archives/edgar/data/1385136/000088237707000094/d609032_fwp.htm; *Best Practices Won't Kill Production at New Century*, p. 3 Inside B&C Lending (November 24, 2006).

[42] *See, e.g.* "B&C Escrow Rate Called Low," *Mortgage Servicing News Bulletin* (February 23, 2005) "Servicers of subprime mortgage loans face a perplexing conundrum: only about a quarter of the loans include escrow accounts to ensure payment of insurance premiums and property taxes, yet subprime borrowers are the least likely to save money to make such payments….Nigel Brazier, senior vice president for business development and strategic initiatives at Select Portfolio Servicing, said only about 25% of the loans in his company's subprime portfolio have escrow accounts. He said that is typical for the subprime industry."

[43] *See*, e.g., "Attractive Underwriting Niches," Chase Home Finance Subprime Lending marketing flier, at http://www.chaseb2b.com/content/portal/pdf/subprimeflyers/Subprime_AUN.pdf **(**available 9/18/2006) stating " Taxes and Insurance Escrows are NOT required at any LTV, and there's NO rate add!", (suggesting that failing to escrow taxes is an "underwriting highlight" that is beneficial to the borrower). 'Low balling' payments by omitting tax and insurance costs were also alleged in states' actions against Ameriquest. *See, e.g.* State of Iowa, ex rel Miller v. Ameriquest Mortgage Co. et al, Eq. No. EQCE-53090 Petition, at ¶ 16(B) (March 21, 2006).

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

[45] In fact, Fannie Mae and Freddie Mac, the major mortgage investors, require lenders to escrow taxes and insurance.

[46] See *Structured Finance*, note 21, p. 4.

[47] Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006); *see also* 2007 Global Structured Finance Outlook: Economic and Sector-by Sector-analysis, FITCH RATINGS CREDIT POLICY (New York, N.Y), December 11, 2006, at 21, commenting that the use of subprime hybrid arms "poses a significant challenge to subprime collateral performance in 2007."

[48] Traditional Rate Sheet effective 12/04/06 issued by New Century Mortgage Corporation, a major subprime lender, shows that a borrower with a 600 FICO score and 80% LTV loan would pay 7.5% for a fully-documented loan, and 9.0% for a "stated wage earner" loan.

[49] *See* Interagency Guidance on Nontraditional Mortgage Product Risks, note 42.

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

[51] About one-third of the states have established, through regulation or case law, a broker's fiduciary duty to represent borrowers' best interests. However, many of these provisions are riddled with loopholes and provide scant protection for borrowers involved in transactions with mortgage brokers.

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

[53] Joint Center for Housing Studies, "Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations," Harvard University at 4-5. Moreover, broker-originated loans "are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors." Id. at 42 (citing Alexander 2003).

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

[55] *Inside The GSEs* (Jan. 3, 2007), p. 4.

[56] Because of the Congressional charters of Fannie Mae and Freddie Mac, Congress requires each corporation to achieve public purposes that include the requirement that the GSEs devote a percentage of their business to three specific affordable housing goals: the Low- and Moderate-Income Housing Goal, which targets families with incomes at or below the area median income, the Special Affordable Housing Goal, which targets very low income families, and the Underserved Areas Housing Goal, which targets families living in low-income census tracts or in low- or middle-income census tracts with high minority populations. See http://www.hud.gov/offices/hsg/gse/gse.cfm

[57] Patrick Crowley, *Repurchases Stinging Subprime Sector*, MortgageDaily.com (Jan. 5, 2007).

[58] 15 USC Section 1639(l)(2).

[59] These limitations concern certain prepayment penalties, post-default interest rates, balloon payments, negative amortization, prepaid payments, ability to pay, and home improvement contracts. See subsections 129(c)-(i). High cost mortgages are those "referred to in section 103(aa)."

[60] Most subprime abuses occur with refinance loans rather than loans used to purchase a house (what HOEPA calls a "residential mortgage transaction", Sec. 152(aa)(1)). HOEPA's enumerated protections are limited to closed end refinance loans that meet the high cost standard. However, section (l) refers to "mortgage loans" generally, which would include purchase-money loans. The fact that section (l)(2) prohibitions are directed at two separate types of loans -- (A) those the Board finds to be unfair, deceptive, or designed to evade HOEPA, and (B) abusive refinancings -- provides evidence that subsection (A) includes purchase money loans as well.

[61] See S.1275, Section 129(i)(2): "PROHIBITIONS--The Board, by regulation or order, shall prohibit any specific acts or practices in connection with high cost mortgages that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section." Reported in 140 Cong. Rec. 3020, S3026. According to the Senate Report, No. 103-169, p. 27, "the legislation requires the Federal Reserve Board to prohibit acts or practices in connection with High Cost Mortgages that it finds to be unfair, deceptive, or designed to evade the provisions of this section."

[62] See House Conf. Rep. No. 103-652, p. 161, "the Board is required to prohibit acts and practices that it finds to be unfair, deceptive, or designed to evade the section and with regard to refinancing that it finds to be associated with abusive lending practices or otherwise not in the interest of the borrower."

[63] "The Conferees recognize that new products and practices may be developed to facilitate reverse redlining or to evade the restrictions of this legislation. Since consumers are unlikely to complain directly to the Board, the Board should consult with its Consumer Advisory Council, consumer representatives,

lenders, state attorneys general, and the Federal Trade Commission, which has jurisdiction over many of the entities making the mortgages covered by this legislation.

“This subsection also authorizes the Board to prohibit abusive acts or practices in connection with refinancings. Both the Senate and House Banking Committees heard testimony concerning the use of refinancing as a tool to take advantage of unsophisticated borrowers. Loans were “flipped” repeatedly, spiraling up the loan balance and generating fee income through the prepayment penalties on the original loan and fees on the new loan. Such practices may be appropriate matters for regulation under this subsection.” Id.