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PRESERVING THE AMERICAN DREAM: PREDATORY LENDING PRACTICES AND HOME FORECLOSURES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

THE IMPACT OF EXOTIC MORTGAGE PRODUCTS ON HOMEBUYERS AND HOMEOWNERS

WEDNESDAY, FEBRUARY 7, 2007

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WEDNESDAY, FEBRUARY 7, 2007

WITNESSES

Additional Material Supplied for the Record *

*Mortgage Broker and Loan Originator Licensing material submitted by the National Association of Mortgage Brokers has been retained in Committee files.

PRESERVING THE AMERICAN DREAM: PREDATORY LENDING PRACTICES AND HOME FORECLOSURES

WEDNESDAY, FEBRUARY 7, 2007

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:03 a.m., in room SH–216, Hart Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. We welcome all of you this morning.

Let me just announced for purposes of how we will proceed here, we will begin the hearing this morning, and at the point we arrive and have a quorum here, I will interrupt the hearing, hopefully for a very brief amount of time, for us to consider the markup of the Public Transportation Terrorism Prevention Act, which is a matter this Committee had dealt with in the past in the previous Congress under the leadership of Senator Shelby. Basically it is the same bill that we passed out of this Committee in the previous Congress, but there is an effort to have this bill become part of a larger bill dealing with homeland security issues, and so we need to get it done in a timely fashion. So as soon as we have a working quorum here, I will interrupt, go into executive session, and then we will deal with that matter. And I will apologize in advance to the witnesses that if you are in the middle of your testimony here, we will take a break and move to that item and then come right back to the subject matter of today's hearing.

I have some opening comments I want to make. I am going to turn then to my colleague and friend, Senator Shelby, for any opening comments he may have. I will ask other colleagues who are here if they have some short opening comments, and then we will turn to our witnesses.

Let me welcome all of you here today for the hearing entitled "Preserving the American Dream: Predatory Lending Practices and Home Foreclosures." This hearing is particularly timely in light of the news that has been coming out in recent days about the wave of delinquencies and foreclosures facing American homeowners.

Let me start by recognizing the work of Senators Allard, Bunning, Reed, Schumer, Senator Shelby as well, who held joint Subcommittee hearings last year to examine the impact of exotic mortgages on homebuyers and homeowners. They deserve a great deal of credit, in my view, for raising the awareness of many of us to the risks of these products. I consider today's hearing a continuation of the work that these members started in the previous Congress.

Today, the Committee will focus its attention more specifically on predatory lending practices that are found primarily in the subprime market and how these practices may be eroding the foundations of homeownership for millions of American families. Let me make myself very clear at the outset on one important point. I do not believe that all subprime or exotic lending is a predatory or abusive practice. To the contrary, subprime credit can be and many times is a valuable tool in helping people become homeowners and in unlocking the equity in their homes. For many years, the battle so many of us have fought was to make credit available to neighborhoods that had been redlined, or to people, particularly minorities, who felt the sting of rejection, regardless of their creditworthiness.

In response to this injustice and after years of hard work by people like Reverend Jackson, Hilary Shelton, and many others, we passed the Community Reinvestment Act and the Fair Housing Act so that credit to buy a home or build a business would be available to all Americans. As a result, we have seen homeownership grow. Every one of us has spoken about homeownership, how it provides stability and a chance to build wealth for the vast majority of Americans. It is the most valuable asset that most of us will ever own. Our homes provide us with a financial cushion on which we can draw to send our children to college, pay for unexpected health expenses, or finance a secure retirement.

To the extent that the creation of the subprime market has added to this flow of credit in a positive and constructive way, in a way that helps build wealth, I welcome that development, and I encourage it. However, it is not enough to simply create homeownership. We must sustain, preserve, and protect it as well. Yet today we are seeing increasing evidence that this important source of wealth for so many of our fellow citizens is under grave threat from predatory, abusive, and irresponsible lending practices undertaken by too many subprime lenders. The borrowers who are too frequently targeted for these loans are minorities, immigrants, the elderly, and the totally unsophisticated. For these families, failure means the loss of a home, the loss of wealth, the loss of middle-class status, and the loss of the opportunity for financial security.

The growth of the subprime market has been incredible. The amount of subprime lending more than tripled from the year 2000 to the end of 2005, from $150 billion to nearly $650 billion. It is now over 20 percent of the entire market. But this incredible growth has come at what the FHA Commissioner Brian Montgomery has called, and I quote him, "a tremendous cost, a cost that often outweighs the benefits of homeownership."

Today, there are too many incentives in the subprime market to make loans that put borrowers at too great a risk of failure. For example, over half of subprime mortgages are stated income loans—loans which the industry often refers to as "liar's loans." The question is: Who is lying? According to a survey of over 2,000 mortgage brokers, 43 percent of the brokers who make these loans do so because they know that their borrowers do not have the income to qualify for the loan in the first place. Why do they make these loans? Because they are paid more to do so. Brokers up-sell borrowers; that is, they put borrowers in loans with higher interest rates than they would otherwise qualify for because the brokers make greater commissions, called "yield spread premiums." By so doing, these yield spread premiums are a perfectly legitimate tool to provide borrowers with no-closing-cost loans. But HUD has told us that half of these loans paid, about $7.5 billion, do not go to closing costs but go simply to increase broker profits.

Minority borrowers are being targeted for higher-cost, subprime mortgages, regardless of their financial health. The 2005 Home Mortgage Disclosure Act data show that over half of African American borrowers and 46 percent of Hispanic borrowers were given high-cost, subprime loans. By comparison, only 17 percent of whites took out such loans. Yet, according to the Federal Reserve, borrower-related characteristics such as income could explain only about 20 percent of this disturbing difference. That is from the Federal Reserve, by the way. About 70 percent of subprime loans have costly prepayment penalties that trap borrowers in high-cost mortgages, mortgages that strip wealth rather than build it, and these penalties keep borrowers from shopping for a better deal.

Unfortunately, living in a minority neighborhood puts a homeowner at significantly higher risk of having a prepayment penalty. Approximately eight in ten subprime loans today are 2/28 adjustable rate mortgages—mortgages whose monthly payments will spike up by as much as 30 to 50 percent or more. Many of the borrowers who take these loans, unaware of the payment shocks that await them, have no prospects of being able to make the higher payments and are forced to refinance the loan if they have sufficient equity to do so. Each refinance generates new fees for the lenders and brokers and strips more equity from the homeowner. One lender in a discussion with my office called subprime 2/28 loans "foreclosure loans." Those were his words, not mine.

Late in 2006, Federal financial regulators issued guidance to require the lenders to underwrite borrowers for certain non-traditional mortgages so that even after the payment shock hits, the lender can be reasonably certain that the borrowers will be able to continue to make the mortgage payments.

Last year, I wrote, along with five of my colleagues on this Committee—Senators Allard, Bunning, Reed, Schumer, and former Senator Sarbanes—asking the regulators to extend these same protections to borrowers who were given these subprime 2/28 ARMs, borrowers that are disproportionately black and Hispanic. That was over 2 months ago we wrote the letter. We have not received an answer yet. My hope is today that as a result of this hearing and referencing to it here this morning, we will get a response from the various Federal agencies that we have written to asking them to respond to our concerns about these practices. I believe these borrowers deserve every bit as much protection as the homeowners who take out interest-only and option ARM loans. And I want to urge the regulators to more expeditiously provide the same protections to these particularly vulnerable borrowers.

The results of these aggressive and abusive practices are becoming clear. The Center for Responsible Lending, whose CEO, Martin Eakes, will testify this morning, released a study saying that nearly one in five subprime loans made in 2005 and 2006 will end in foreclosure, in large part because of the abusive loan terms with which many low-income borrowers are saddled. According to this study, up to 2.2 million families will lose their homes at a cost of $164 billion in lost home equity. Other reports confirm the trend. RealtyTrac announced that there were more than 1.2 million foreclosure filings in 2006, up 42 percent from 2005, blaming the increase on higher payments generated by the resets on option and subprime ARMs.

Today's edition of the American Banker has a story entitled "Subprime Defaults at Recession Level." The article focuses on a study conducted by Friedman, Billings, Ramsey, an investment banking firm specializing in mortgages, which says that over 10 percent of securitized subprime loans are seriously delinquent, over 90 days late, in foreclosure, or already turned into seized properties. This is nearly double the rate from May of 2005 and higher than at any time since the recession of 2001.

I understand that many argue that the impact of the economy and other life events, as they are called, such as illness, job loss, divorce, and the like, are key variables in determining mortgage delinquencies and foreclosures. No doubt this is true. I do not question that. But these economic and personal factors do not fully explain, in my view, the precipitous rise in defaults and foreclosures. It is time for Congress, the administration, and the lending industry to face up to the fact that predatory and irresponsible lending practices are creating a crisis for millions of American homeowners at a time when general economic trends are good. Indeed, Mark Zandi, chief economist at moodysconomist.com, notes that, "The current high delinquency rates are unusual because the economy is relatively strong." I am quoting him there. Zandi attributes the increasing delinquencies in part to the resetting of subprime and other ARMs at higher rates. This is particularly worrisome given the fact about $600 billion in ARMs were reset this year. The problem is most of these loans are perfectly legal, even as they do real harm to borrowers and neighborhoods. In short, the system is out of balance. There is a chain of responsibility that makes these abusive loans possible. I look forward to working with each link in that chain—the brokers, the bankers, Wall Street, the regulators, my colleagues on this Committee, and the Congress and the administration—to help restore this balance for the sake of the safety and soundness of the banking system, for the sake of homeowners who are being victimized, and to make sure that subprime credit can once again play a very constructive role in the marketplace and make homeownership the dream that it ought to be.

At any rate, here now this morning let me, if I can, note that Reverend Jackson is here and will be our lead-off witnesses, but before I turn to him, I want to turn to Senator Shelby for some opening comments and then any other Members of the Committee for any opening comments they may have, and then we will turn to our witnesses.

Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Chairman Dodd.

The last 10 years have witnessed a dramatic increase in homeownership, particularly among low-income and minority families. One of the primary reasons for this increase has been the advent of risk-based pricing in the mortgage market. The resulting expansion of mortgage credit has opened the dream of homeownership to millions of Americans who previously would not have qualified. We in the Congress have a responsibility to ensure that this upward trend continues.

The market now provides a wide array of mortgage products to meet the needs of a diverse consumer base. Unfortunately, more choices mean greater complexity, which can put some borrowers at a disadvantage. Therefore, it is incumbent upon consumers not only to educate themselves, but to shop around before they sign on the dotted line. Due diligence alone, however, Mr. Chairman, cannot protect the consumer from fraud and other unscrupulous practices.

The financial regulators possess a number of tools to eliminate discriminatory, unfair, fraudulent, and deceptive practices. In fact, the bank regulators recently issued final guidance on non-traditional mortgage products. I believe this guidance will help further reduce abusive and irresponsible lending.

We also have a responsibility, Chairman Dodd, to ensure that this downward trend also continues. This Committee has highlighted and will continue to highlight both the good and the bad in the mortgage marketplace in hopes of facilitating the former and eliminating the latter.

I look forward to working with Chairman Dodd as we monitor the performance of the regulators and determine what, if anything, Congress can do to further reduce abuse and fraud while ensuring the continued expansion of homeownership.

While we seek to protect the few who have fallen prey to either bad actors or their own choices, we must be careful not to inadvertently harm the many who have benefited or will benefit from expanding homeownership.

As Reverend Jackson has observed in the Chicago area, it is possible to throw the baby out with the bath water when we seek to legislate in this area. We have got to strike a balance to get it right.

Mr. Chairman, I want to commend you for your efforts and the efforts of our former Chairman, Senator Sarbanes, in making financial literacy a top priority of this Committee. An informed consumer is a powerful deterrent to those who seek to defraud or deceive potential borrowers. More importantly, an informed consumer is in a much better position to choose the most appropriate loan for their specific economic circumstances.

Mr. Chairman, I also want to thank today's witnesses for their willingness to appear before this Committee, and I look forward to hearing from them. Thank you.

Chairman DODD. Thank you very much, Senator Shelby.

Let me turn to my colleagues for any opening statements. Senator Reed, any opening comments?

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman. I want to thank you and Senator Shelby for this hearing on the important topic of ipredatory lending.

In the third quarter of 2006, in Rhode Island more than 5,600 home loans were delinquent, and for a small State like Rhode Island, that is a significant number. More than 600 mortgages fell into foreclosure proceedings. That is up 41 percent since 2005. Those are startling numbers. But what is happening, obviously, is that increased housing prices and flat wages have put a lot of families in a very difficult predicament. And according to statistics, in 2006 nearly 16 percent of the loans in Rhode Island were interest-only. Those are just the type of loans that could lead to the situation we talked about today. As interest rates accelerate, families find themselves caught between stagnant wages and family crises like health care and other problems, and that is where we have to, I think, do something much more.

I am interested particularly today in what the Federal Government might be able to do to provide some type of relief for homeowners, provide them a lifeline. One of the greatest challenges facing policymakers, nonprofit housing support entities, and responsible lenders appears to be reaching borrowers in trouble. As a result, I have been working on legislation which I plan to introduce soon that would improve and expand upon existing Federal efforts to reach borrowers in trouble. Federal sponsorship of post-purchase assistance activities would help ensure that Federal dollars invested in homeownership programs, including purchase assistance programs and the FHA, are not wasted, while also providing benefits to buyers and lenders. I think we can do much more to help those people facing foreclosure, and we should do it.

I look forward to the hearing to learn more about this particular issue, and I thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Tester, any comments?

STATEMENT OF SENATOR JON TESTER

Senator TESTER. Thank you, Mr. Chairman and Ranking Member Shelby. Thanks for holding this hearing on an issue that has adversely affecting more and more Americans every day: predatory lending.

Hard-working Americans think they are finally achieving part of the American dream—homeownership—and they find themselves in a financial tailspin because they were loaned more than they could afford, with hidden fees and interest rates that explode after a few years.

Now, Mr. Chairman, you remember a couple weeks ago we had a hearing here on credit cards. This type of lending where we have exploding fees—I mean hidden fees and exploding interest rates is becoming far, far, far too common. You spoke of one in five subprime borrowers that could lose their homes. These are statistics that, quite frankly, are very troubling because behind these statistics are young families, minorities, people that are going to suffer greatly. Clearly, more needs to be done to protect consumers from these predatory lending practices, and I look forward to hearing the testimony and the panel on this subject.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman. To Reverend Jackson and other witnesses, welcome. We are delighted that you have joined us today.

Long before I came to the Senate, homeownership was a top priority for me. As Governor of Delaware, we sought to make—we literally took our Housing Authority Director and put her on our Cabinet. Then we worked hard to raise our homeownership rate. Our homeownership rate in Delaware is about 75 percent, among the highest in the country. I think all kinds of good things flow out of homeownership in terms of a source of savings for us to send our kids to school, start small businesses, live on at the end of our lives with reverse mortgages. We know kids do better in school when they live in a home that their family owns. People take ownership of their community. Just all kinds of good things flow from homeownership.

So I have been anxious to and still do a lot in my little State to promote homeownership. And while I am encouraged by increased homeownership rates, I want to ensure that financing options that get people into a home are not subsequently counterproductive. And I want to see more Americans own their own homes, but I also want to make sure that they can actually stay in their homes and realize the American dream, not just for a couple of months or a couple of years, but for the rest of their lives.

However, the process of buying a home can be daunting, as we know. Obtaining a loan can be an intimidating and confusing process for the vast majority of people who participate in it. Today there are many financing options for potential homebuyers as we know. I would just ask a rhetorical question: What makes a loan predatory? And, unfortunately, we have no clear definition. We have lists of examples, but does one practice in isolation by default become predatory? Or do there have to be two or three practices in one transaction in order for it to be predatory? How we craft a definition of "predatory" and define restrictions will have important consequences for the future of homeownership in America.

For some, the subprime market is appropriate. You have spoken to that, Mr. Chairman, just as long as it is fair and clear. Because of the subprime market, we actually have the opportunity for a lot of people to have access to credit who would not otherwise have it. But if restrictions on such practices go too far, there is a risk that subprime lending will be too high for lenders and they will not make loans to people who need it and who have earned it. On the other hand, if the restrictions are too loose, then many Americans may lose the equity they have built up in their homes, they may lose their life savings, they may lose their family's home.

An important component of increased American homeownership is financial literacy. We have had hearings on that, as you will recall, and we must do our best to impart consumers with the knowledge that they need to successfully purchase a home. The state of financial literacy in our country, despite our efforts, is abysmally low, and we need to educate our children and continue to educate our children, our young adults, and, frankly, our older adults on the basic skills such as personal budgeting, balancing a checkbook, checking their credit scores, and so forth. Increasing financial literacy will go a long way to protecting Americans from finding themselves in financial situations they cannot afford.

In closing, Mr. Chairman and colleagues, obviously I greatly appreciate that we are holding this hearing today. I hope that our Committee will continue to examine this and other homeownership issues to find ways to address these issues, not only these issues but financial literacy as well, and my old favorite, a strong, independent regulator for those Government-sponsored enterprises.

Thank you.

Chairman DODD. Thank you very much, Senator Carper.

Senator Casey.

STATEMENT OF SENATOR ROBERT P. CASEY

Senator CASEY. Mr. Chairman, thank you for bringing us together for this important hearing, and I want to thank all the witnesses who will appear, and especially Reverend Jackson for your testimony that we will hear today and your leadership.

This is an issue much like the minimum wage. We debated that recently, and it was 10 years long overdue before we acted in the Senate to raise the minimum wage. At the time I said that that was an issue of economic justice, and I believe this issue as well is an issue of basic economic justice, because I believe when you go down—and I am glad that Chairman Dodd went through the practices, whether they are financing high points and fees or whether it is loan flipping or aggressive marketing and all of that, all of those pernicious and offensive practices constitute an effort to not only deceive and not only rob people of their financial resources and make it harder for them to make ends meet, it robs them of their dignity, and that is especially offensive when people are in many cases working, they are low-income workers, and they are struggling every day just to bring the ends of their family budget together and all of the pressures that others have mentioned today—health care and education, all the other financial pressures.

But this is something that robs people of their basic dignity, and it is particularly offensive. And I think that one of the results of this hearing has to be—maybe not today, maybe not tomorrow, but soon—to develop a set of changes and practices, policy changes really, that will help to restore some of that dignity that has been lost and prevent others from being the victims of that kind of outrageous conduct.

So, Mr. Chairman, I appreciate your work and your leadership on this, and Senator Shelby and Members of this Committee who have been working on these issues for many years, and we are grateful for this opportunity.

Chairman DODD. Thanks very much.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Chairman Dodd, and thank you for conducting this hearing.

Just last week, Secretary Paulson testified to this Committee and repeatedly told us that in the last quarter we saw 3.5 percent economic growth in this country as if that were the whole story. But my State and Pennsylvania and so many other States are faced with some of the highest foreclosure rates in the country. Cities like Cleveland are being particularly hit hard. There is no question that some of this problem stems from the loss of jobs or other reasons external to the home lending industry, but in far too many cases homeowners have been lured into loans they had no business taking out.

Over the past decade, foreclosure filings have increased fourfold in Ohio. In one Ohio survey, two-thirds of county sheriffs' departments cited predatory lending as a top contributor to foreclosures. The result is that in 2005 there was one foreclosure filing for every 71 households in Ohio. It is not hard to see how this happens. A homeowner might take out only one or two mortgages in her whole life or in his whole life. Doing so is unfamiliar. It is daunting, as Senator Carper said. It is only natural to rely on somebody who deals with mortgage products every day and seems to have the borrowers' interests at heart.

But unscrupulous actors have their own interests at heart. We need to provide greater protections for consumers who may not be sophisticated about the proliferation of mortgage products and the many tricks that can be used to disguise the true cost of a mortgage. We need to act to ensure not just full disclosure but ethical behavior on the part of all the participants in the lending process.

I would close, Mr. Chairman, by asking unanimous consent to enter into the record a statement from the National Association of Realtors, who have, obviously, interest in this, not a direct stake, perhaps, in the hearing today.

Chairman DODD. Without objection, so ordered.

With that, let's turn to our first witness. Reverend Jackson, we thank you immensely for being here, if you would please join us at the table.

As I think most of the audience is aware, Reverend Jackson is the founder and President of Rainbow/PUSH Coalition, one of America's foremost civil rights, religious, and political figures. Over the past 40 years, Reverend Jackson has played a major role in every movement of empowerment, peace, civil rights, gender equity, and economic and social justice, also broke new ground in U.S. politics with his two runs for the Presidency back in the 1980's.

Reverend Jackson has received numerous honors for his work in human and civil rights, nonviolent social change, and he has received the prestigious NAACP Spingarn Award in recognition of his honors from hundreds of grass-roots civic and community organizations from coast to coast. On August 9, 2000, President Bill Clinton awarded Reverend Jackson the Presidential Medal of Freedom, the Nation's highest civilian honor.

Reverend Jackson, it is a pleasure and honor to have you before this Committee. We thank you for being with us.

STATEMENT OF REVEREND JESSE JACKSON, PRESIDENT AND FOUNDER, RAINBOW/PUSH COALITION

Reverend JACKSON. Thank you, Senator Dodd. Mr. Chairman, Senator Shelby, other distinguished Members who are here today, I want to thank you for your vision in calling today's hearing as well as your insightful comments at the tenth anniversary of the Rainbow/PUSH-Wall Street Economic Project Summit, established to democratize capital in the financial services industry and remove the walls on Wall Street for people of color and women and seniors. We look forward to joining with you in a working group on the issue of predatory lending and other issues which will form the basis of a new national urban policy for America.

On Thursday, January 25th, this same Committee held hearings on the practice of the credit card industry. What we will see here today is that several of the issues prevalent in the credit card industry apply to the issue of predatory lending as well. I would like to thank Senators Allard and Bunning, who held hearings last year on interest-only mortgages. After all, in a true democracy, money is not red or blue or white. It should be green for all citizens.

As we gather for this hearing in the month of the year designated for the commemoration of Black History, we do so through two lenses of history: triumph and tragedy. NFL coaches who are black are recent triumphs in breaking down walls of exclusion in athletics, and that is a triumph, and the tragedy of the financial services industry's targeting of people of color for high-rate mortgage continues.

What is the American creed? The American creed promises equal opportunity, equal access, equal protection under the law, and a fair share for all. Forty years after the passage of the Civil Rights Act of 1964 and the Voting Rights Act of 1965, we must level the playing field for all citizens, identify incentives for our financial institutions to invest, not exploit and oppress, hard-working Americans. Far beyond our idea of freedom is the reality of equity and parity. We must break the syndrome where the poor pay more for automobiles and housing financing to insurance.

Today's terms of credit for African American and Latino borrowers and seniors are un-American. The cost of money for black and brown people is not based on equal opportunity, equal access, or equal protection under the law. In the home mortgage industry, like other industries, people of color are economically exploited, resulting in a home-owning rate of fewer than 50 percent.

For example, in 2005, 52 percent of mortgage loans to blacks were high rate, 40 percent of mortgage loans to Latinos were high rate. By contrast, in the same year, only 19 percent of mortgage loans to whites were high rate.

In Chicago alone, foreclosures for black and brown borrowers exceed $598 million annually. In Boston, 70 percent of middle-class—not the poor—home loans were high rate. Nevada has the second highest foreclosure rate in the Nation. When the Ford Motor Company dismisses 55,000 workers, and Honda and Toyota can build plants here and Ford cannot build a plant there, we also need not only literacy but a fair trade policy. Or if you have another hearing in the field, please have it just outside of a military base where underpaid soldiers are just victimized by vultures of whatever race all over our Nation.

So when you lose 3 million manufacturing jobs, you don't just need literacy. You need a job that can pay your mortgage. The ghetto barrio established as an enclave or institution built on race, exclusion and exploitation. It required open housing laws to relieve pressure on the overcrowding and create housing options.

There remains a zone of high taxes and low services, second-class schools and first-class jails, zip codes that are unprotected by law. It is a fertile land for predators, financed by banks. Banks lock you out based on credit score and zip code, and market exploiters, payday lenders, swoop in like vultures. We need Federal protection. The help of CRA on the front side is a good thing. But then when banks finance predators on the back side, they offset CRA.

Many players in the home mortgage industry are given a green light to engage in predatory schemes to redline against the poor and people of color. Predatory lending practices such as subprime loans are the largest threat to wealth accumulation. Practices include steering, placing borrowers into higher-priced loans than those for which they qualify; steering of prime, placing black and brown borrowers into high-cost subprime loans; prepayment penalties, fees incurred by borrowers for paying a loan off early; yield spread premium, broker kickbacks for steering borrowers into high-priced loans; no-fault repayment ability, failure to escrow for property taxes, low documentation loans.

Today, I pray the Senate Banking Committee does not, A, blame the victims who work harder and make less, pay more for less, live under stress, and don't live as long, or suggest a mere increase in disclosure forms. I respectfully suggest, one, the industry is not functioning properly nor fairly. Lenders and brokers have financial incentives to place borrowers in more expensive loans. It puts responsible lenders at a competitive disadvantage with the irresponsible lenders, allowing unscrupulous predatory lenders to control the market. Currently, brokers get paid more by putting borrowers in more expensive loans for which they qualify, and lenders have incentives to place borrowers in loans that are unsustainable for more than a year or two. This must change.

The GSEs, the Government-sponsored enterprises, lenders worked with these organizations in Fannie Mae to develop predatory lending practice guidelines which have been adopted. What we find these basic banking services for whites, full-service bank branches. For Blacks and Latinos, pawnshops, check-cashers, and payday lenders.

Current evidence reveals that Fannie Mae is purchasing securities that include the very loans that are stripping working-class people of their precious home equity. The Federal Government subsidizes Fannie Mae to increase homeownership, opportunities for working people. In purchasing such securities and profiting from predatory loans, Fannie Mae is violating its public mission and the ability-to-repay standard. I have also learned that Fannie Mae has received HUD Goals Credit for investing in high-rate loans that produce massive foreclosures. In short, Fannie Mae and other GSEs are doing through the back door what the law prohibits through the front door. This must change.

Last, borrower should not shoulder the blame. I am very discouraged by the industry response to necessary change when I heard from industry, "Educate the borrower and increase disclosure." I would rather be an ignorant borrower with a job than an enlightened one without a job. The loss of jobs is a big factor in inability to pay.

Rainbow/PUSH, through our Thousand Churches Program, teaches financial literacy through member churches across the Nation, and there are other organizations doing the same to provide borrowers with information to make good financial choices. To think that more forums and more 1–800 numbers is the remedy is to view the issue through a keyhole and not the entire. Duty-to-Read standards for the public must be matched by a duty to behave for predatory lenders.

In closing, Federal law requires banking regulators to protect citizens regardless of race. We need a domestic OPIC—long-term, low-interest, flexible loans. We need a development bank, as we build for allies, as we seek to be sensitive and helpful, expand markets abroad, the ghetto, the barrio is likened unto a Third World country except it is closer, more secure, and more lucrative. The ghetto is an underserved market, underutilized talent, untapped capital, and thus, growth potential.

We must enforce laws against racial discrimination. We must greenline the redline zones and zip coded zones and use Government-private partnerships to break this pattern. We must see the underserved markets as an opportunity for growth and development rather than exploitation and unscrupulous profiteering.

What we fight for is one set of rules, evenly applied to all Americans, whether Native Americans, African Americans, Latino Americans, Asian, or European.

Last, we just saw the Super Bowl game this past Sunday. The reason why so many people could see it and accept the victory with grace and the loss with some degree of sorrow, but say next year, and no uproar—why have we done so well on the athletic field? Why do we accept black coaches and blacks and whites in combat, and at the end of the day leave with a sense of everybody won? Because whenever the playing field is even and the rules are public and the goals are clear, we can all play—win, lose—and have our dignity. In this industry, the playing field is not even, the rules are not public, the goals are not clear, and exploiters abound.

Thank you very much.

Chairman DODD. Thank you very much, Reverend Jackson. We appreciate your testimony.

What I am going to ask if we can make a little room for other witnesses coming up with your aides there. Let me introduce our other witnesses, and then they will make some opening statements. I want to ask our witnesses to try and keep their remarks to about 5 minutes so we can get to the Q&A period, if we can.

Let me welcome Ms. Delores King of Chicago, Illinois, and Ms. Amy Womble, if I have pronounced that correctly, and you correct me if I am wrong in that pronunciation—Womble, I guess it is. Let me just say to both of our witnesses here, these are not witnesses that normally appear before congressional hearings, and we are very honored that both of you are here and are willing to share your stories with us. You put a face on all of this. We talk in these details and numbers, about the impact of these decisions, and yet sometimes we lose sight of the fact that there are very real people who are affected by these decisions. So we are very grateful to you, Ms. King, for being here this morning to join us, and you, Ms. Womble—did I pronounce that correctly? How do you pronounce your——

Ms. WOMBLE. Womble.

Chairman DODD. Womble. We thank you as well for coming here this morning.

Our next witness will be Harry Dinham, who has worked in the mortgage industry for 38 years. Harry, we thank you for joining us here this morning. Join us at the table. Mr. Dinham is President and owner of the Dinham Companies, including the Dinham Mortgage Company in Plano, Texas. He is here in his capacity as President of the National Association of Mortgage Brokers. He has been a long-time and very active member of that association. He has served as the Treasurer, the Vice President, and President-Elect before taking the office of the President on June 25th. And, Mr. Dinham, we thank you for joining us here as well and for your testimony this morning.

Jean Constantine-Davis is an attorney with AARP since 1985, currently working in the Foundation Litigation Group on issues involving fraudulent and predatory mortgage lending practices targeted at elderly homeowners. She was awarded the Jerrold Scoutt Prize for her work on behalf of low-income, vulnerable elderly here in the District of Columbia. We thank you for joining us, Ms. Davis.

Mr. Hilary Shelton is the Director of the NAACP's Washington Bureau, the Federal legislative and national public policy division of the over 500,000–member, 2,200–membership unit, national civil rights organization. He is responsible for advocating the Federal public policy issue agenda for the oldest, largest, and most widely recognized civil rights organization in the United States. Hilary, thank you for joining us here this morning as well.

Following Hilary Shelton, we will hear from Dr. Douglas Duncan, who is the Chief Economist and Senior Vice President at the Mortgage Bankers Association. As leader of MBA's Research and Business Development Group, Mr. Duncan is responsible for providing economic and policy analysis services in the areas of real estate, finance, legislative, and regulatory proposals, and industry trends for MBA and its members. Mr. Duncan, thank you very, very much for joining us this morning.

And, last, we will hear from Martin—and I am going to mispronounce this.

Mr. EAKES. Eakes.

Chairman DODD. Eakes. Martin Eakes, who is the Chief Executive Officer of the Center for Responsible Lending and the Center for Community Self-Help, which is a community development leader that has provided over $4.5 billion in financing to more than 50,000 homebuyers, small businesses, and nonprofits nationwide. Self-Help reaches persons who are underserved by conventional lenders, particularly minorities, women, rural residents, and low-wealth families. Mr. Eakes has been a leading voice nationwide in the fight to end predatory lending. I have already quoted you this morning in my opening statement, and we thank you as well.

We have got a very distinguished group of panelists here, very knowledgeable people. We are going to begin in the order that I have introduced you. Again, if you would try to limit your comments to about 5 or 6 minutes, I am not going to hold you to that rigidly, but it would help us get to the question-and-answer period.

Ms. King, thank you. And if you want to pull that microphone up close so you can be heard, and again, I am very grateful to you for coming this morning. It means a lot to have you here. We thank you.

STATEMENT OF DELORES KING, CONSUMER, CHICAGO, ILLINOIS

Ms. KING. Thank you for the opportunity to testify here today about my mortgage. My name is Delores King, and I live on the South Side of Chicago in a home I have owned for 36 years. It will be 36 years in August. I am a retired office administrator after 28 years on the job in the offices of the Illinois College of Optometry.

Over the years, I have refinanced several mortgages on my property in order to make repairs and various improvements. In 2004, my mortgage balance was $140,000, and I was paying $798 per month on my mortgage. In 2004, unfortunately, I was a victim of identity theft, a phony check scam that cost me about $3,000. I decided to refinance my mortgage in order to borrow the money I owed as a result of the scam. What happened next is that I was defrauded into a horrible mortgage that is so bad, I could lose my home.

Around February 2005, I received a telemarketing call from Chad, a mortgage broker with a company called Advantage Mortgage Consulting. Chad told me that he could get a loan for me approved fast. He said he would get me a good loan for my situation. So I applied for the loan with Chad. I told Chad that my monthly income was about $950 per month from Social Security. My only other income is a one-time-a-year retirement payment from the Teachers Pension from the Optometry School in the amount $2,657 once a year. This pension will actually stop in a few more years. Currently, I have a part-time job as a foster grandparent at a grade school, where I make $2.65 an hour. Chad took my copies of my Social Security card and pension benefit statements, and a few weeks later he told me I was approved. He brought the loan papers to my house, and he asked me to sign many, many pages of documents. He rushed me through the signing and did not really explain anything. He certainly did not say this was an exotic loan or unusual in any way. He did not even give me a copy of the papers I signed. I had to call and get them from the title company much later.

When I agreed to the loan, Chad said it was adjustable rate, but the starting interest rate was only 1.45 percent. He said the regular rate would be around 6 percent and the payments would be around $800 per month. I believed that the starting rate would last at least 6 months or a year before adjusting. I have heard about mortgages that adjust once a year. I knew that the payment could go up little by little, but I had no idea it would explode the way it has in just 2 years. I also did not know that $800 per month was less than all of the interest due and that my balance would go up and up with unpaid interest. So now I have a mortgage that is thousands of dollars more than I started with, and my payments have nearly doubled in 2 years. I have refined before, but I have never seen anything like this. The payments started with $832 a month, including taxes and insurance. The monthly payment as of now is $1,488 per month. This is more than my entire monthly income. I have to scrape by with the help of my family members and friends to get my mortgage paid every month, but now I am at the point where it is just impossible to continue. Last month, I could only send $1,200. I will end up on the street if something doesn't change soon.

I had never heard of a no-doc loan or an option loan before all this happened. I never knew you could get a mortgage and pay interest only or even less than all the interest owed each month. I surely did not know that a bank would make a loan to someone without checking to see if the person could afford the loan. This loan is just not right for somebody like me. If the bank had looked at my information, my income, they knew I could never afford this loan. The bank knew, but I did not know that the monthly payments could go higher than my entire monthly income, my fixed income.

It should be against the law for a bank to make a loan knowing that it will be impossible for people to pay it back and they will lose their home.

Chairman DODD. Ms. King, thank you very, very much. There is someone sitting down a couple of seats away from you who lives around Chicago. Maybe you can talk to him before we leave here.

Reverend JACKSON. To be sure.

Chairman DODD. Ms. Womble, thank you for coming. Pull that microphone down so we can hear you, too.

STATEMENT OF AMY WOMBLE, CONSUMER, PITTSBORO, NORTH CAROLINA

Ms. WOMBLE. Thank you for inviting me today.

Chairman DODD. You have got to pull it even closer. I am sorry. Get right up close to it.

Ms. WOMBLE. Thank you for inviting me today. My name is Amy Womble, and I live in Pittsboro, North Carolina. I have two sons. Joshua is 18 and Jeremy is 16. My husband, Dale, died unexpectedly in October of 2000 at the age of 37. At that time I had excellent credit, as he did. We built a house on five acres. We had a mortgage we could afford. We ran a small construction company together. And after Dale died, I struggled with my boys alone without the business income. I was still personally liable for a lot of the company debt. Even though we were a S Corporation, the company debts that I could not pay were tacked on to my credit report. And then I found out last year a $10,000 judgment had been filed against me personally for an old business debt. And at the time I was worried about how I would repay it. And then one evening while I was on the computer, a pop-up ad came up on the screen that caught my attention: bad credit, no credit, you know, we will refinance you.

So it was for debt consolidation with low interest rates, so I contacted—I sent an e-mail, and then right away they contacted me back, and it was a mortgage broker from California. So he arranged to refinance my home with a mortgage company, Saxon Mortgage. He sent me a good-faith estimate showing the new monthly payment would be $927; my closing costs would be about $8,000; and at closing, I would receive about $26,000 in cash to consolidate the other bills.

All this sounded great to me, so I said let's go ahead and do it. Well, my closing, for one reason after another, kept getting delayed. The loan officer told me not to make my mortgage payment that month because we were going to close any day and I did not need to make that payment. So when the mortgage finally took place—I had spent the mortgage money on medical bills that I needed to pay because I did not have medical insurance. And at that time I felt pressure that I had to close the loan, there was no choice, because I had not made the payment.

Then when I saw the new good-faith estimate at the closing table last June, the monthly payment had jumped from $927 with escrow for taxes and insurance to over $2,100 a month without escrow. The closing costs had jumped from $8,000 to over $12,000. I did not want to sign the papers, but at the time it was the end of the month, and I had no choice. But the broker told me that I would only have to make one payment at that higher level. He had a credit specialist who he was setting me up with who was going to help get all the negative things removed from my credit report and get my credit score cleaned up so that he could then turn around and refinance me and get me the $927 monthly payment. He promised that that would take place within just a couple of months. He was very nice, very concerned. I felt he was sincere. And then since I got closed, we got the loan closed, I started calling him. He never returned my calls. He would not answer the phone. I left messages for over 5 months. So I did not get the credit repaired that he had promised or help with the low monthly payment that he had promised. I was truthful in everything I told him, but he doubled my household income on the loan application from documented Social Security income of $2,751 a month to over $5,000. I did not know that he had misrepresented my income until well after the closing.

Now I know the worst of it all involves the terms of the loan itself. My loan is an adjustable rate mortgage with a current interest rate of 10.4 percent with an APR of 12.5, and the interest rate can go as high as 16.4 percent. Then after 30 years, I still owe a final balloon payment of $176,000. I had no idea this loan even had a balloon payment until last week. I thought I was getting a fixed payment of $927 with taxes and insurance, and I got a starting payment of $2,147, and it only goes up from there and does not include my taxes and insurance.

I thought I would pay this loan off in 30 years. Instead, I have a huge balloon. I gave up a fixed-rate note with a lower monthly payment for this adjustable rate balloon note with a higher payment—a payment that takes up 78 percent of my monthly income. And when you add taxes and insurance, I am paying 86 percent of my monthly income. This leaves $388 a month for my family to live on.

Since I took this loan out, I have had to access equity in my home to meet the monthly payment and to pay other bills. At times there is barely enough money to buy groceries.

I cannot afford this loan, and I am very worried that I am going to lose this home, the home that my children have lived in almost half their lives, and the only constant that has been in their lives for the past 6 years since the death of their father. I thought I was making a smart decision, but this loan has turned into a nightmare.

Chairman DODD. Thank you very much, Ms. Womble.

Ms. WOMBLE. Thank you.

Chairman DODD. Mr. Dinham.

STATEMENT OF HARRY H. DINHAM, PRESIDENT, NATIONAL ASSOCIATION OF MORTGAGE BROKERS

Mr. DINHAM. Good morning, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. I am Harry Dinham, President of the National Association of Mortgage Brokers. NAMB is committed to preserving the American dream of homeownership.

Chairman DODD. Mr. Dinham, can I tell you, and I want to—I have read your testimony. It is long testimony. We are going to include all of it in the record. I want you to know that.

Mr. DINHAM. This is just 5 minutes.

Chairman DODD. Oh, there is an abbreviated one? Thank you very much. I wanted you to know I had read it. It took me a lot longer than 5 minutes to read it.

[Laughter.]

Mr. DINHAM. I will not read the whole thing.

Chairman DODD. I apologize. But I wanted you to know all of it will be in the record.

Mr. DINHAM. I understand. NAMB is the only trade association devoted to representing the mortgage broker industry. We speak on behalf of more than 25,000 members in all 50 States and the District of Columbia. Mortgage brokers must comply with a number of State and Federal laws and regulations. We are subject to the oversight of not only State agencies but also HUD, the FTC, and to a certain extent the Federal Reserve Board. I have this chart with me today which outlines State regulations for all mortgage brokers.

First let me say that it is a tragedy for any consumer to lose their home to foreclosure. No one disputes this. At the same time, today America enjoys an all-time record rate of homeownership, almost 70 percent. The challenge we face now is how do we help people avoid foreclosure while at the same time ensure they have continued access to credit.

A number of recent reports have focused on the rise in home foreclosures. Some claim foreclosure rates are approaching 20 percent. Based on their definitions and sampling, NAMB questions the accuracy and narrow focus of these reports. The truth is we can only speculate on the causes responsible for any rise in home foreclosures. There are a number of possible factors: bankruptcy reform, minimal wage gains, credit card debt, decreased savings rate, decreasing home values, second homes, fraud, illness, and other life events, to name just a few.

Do not rush to judgment before we have all the facts. We urge this Committee to request a study of the reasons for foreclosure. It should take into account a number of possible and non-economic factors. The study should account for product, pricing, seasonal, and market changes. We should examine the conclusion before implementing any policy decisions that could unfairly curtail access to credit.

In the mid–1980's, Congress asked this industry why there was a credit crunch. Many underserved communities had no access to credit. Over the years, industry has increased access to credit with the help of Fannie Mae, Freddie Mac, and the secondary market.

In 2002, our President challenged industry to increase minority homeownership by 5.5 million families by 2010. Mortgage originators, realtors, lenders, underwriters, and the mortgage securitizers and investors on Wall Street responded. We have helped families by expanding access to credit, lowering downpayment requirements, and reducing cash needed at closing. The market is robust—more products, more choices, and more consumer shopping than ever before. More people own their homes. With this said, all of us—industry, Government, and consumers—have a role to play in preventing foreclosures and predatory practices.

Here is some of what NAMB is doing: We have pushed for education and criminal background checks for all mortgage originators since 2002. We have prepared and submitted to HUD a revised good-faith estimate to help improve comparison shopping. We have amended our Code of Ethics and best business practices to prohibit placing pressure on or being pressured by other professionals. We have educated and urged both HUD and the FTC to take action against abusive use of affiliated business arrangements that trap consumers into high-cost mortgage contracts. And we support FHA mortgage reform and authorizing VA to provide reverse mortgages to further expand access to credit.

Today, NAMB is proposing the development of a loan-specific payment disclosure to be given to consumers at the shopping stage and again at funding. This will help consumers avoid payment shock.

Thank you for the opportunity to appear here before you today. I am happy to answer any questions.

Chairman DODD. Thank you very much, Mr. Dinham, and, again, thank you for your full testimony, and we look forward to your responses to questions.

Ms. Davis, thank you for being here.

STATEMENT OF JEAN CONSTANTINE-DAVIS, SENIOR ATTORNEY, AMERICAN ASSOCIATION OF RETIRED PERSONS (AARP)

Ms. CONSTANTINE-DAVIS. Chairman Dodd, Ranking Member Shelby, Members of the Committee, thank you for the opportunity to share our experiences and concerns about the problem of mortgage foreclosure in this country.

AARP attorneys have represented older homeowners in foreclosures on abusive mortgages for over 15 years. The accumulated home equity and limited incomes of older homeowners have made them a primary target for these abuses. We are very concerned now that the current combination of minimal underwriting standards and exotic mortgage products has created a perfect storm that is driving homeowners into foreclosure. Allow me to give you three examples.

In 1992, we represented Paul Pitman, an 82-year-old retiree whose incompetence in later years made him easy prey. His home was debt free when he was manipulated into a $60,000 refinancing with 16 points at a 17-percent interest rate. His mortgage payment was $800 a month. So was his income. The mortgage was starkly unaffordable and was typical of the subprime mortgages at that time.

After 1994, HOEPA had its intended effect and drove these products out of the market. But HOEPA did not end predatory lending. In 1999, we represented ten elderly and unsophisticated homeowners in a case against a single lender. While a few had HOEPA loans, most squeaked just under HOEPA thresholds. All had one thing in common: None could afford their mortgages. They had worked all their lives—in the kitchen at NIH, in the Library of Congress as a housekeeper. Each had struggled to buy a house. Most had raised children in them and were now retired on Social Security and small pensions. So you can imagine our surprise when we discovered tax returns in their files that identified them as self-employed bookkeepers, accountants, seamstresses, and in the case of an 84-year-old stroke victim in a wheelchair, a computer programmer earning $30,000 a year. We discovered evidence that the broker and lender fabricated these tax returns.

We wrestled with these practices, thinking that if the large banks that bought the mortgages had followed their underwriting guidelines, these loans would never have happened. Recent developments, unfortunately, have forced us to revisit that conclusion. Historically, mortgage applicants have been required to verify ability to repay. I have vivid memories myself of our first mortgage and worrying about whether we would qualify to meet the 28-percent mortgage debt-to-income ratio that was the industry standard at that time. I am dating myself. All of that has changed dramatically.

The secondary market, which now controls mortgage products offered and underwriting standards applicable, has made stated income and low- or no-doc mortgages widely available. The most recent innovation is the no-income, no-asset loan, where the income and the asset sections of the loan application are simply left blank. NINAs may be useful to sophisticated investors, but are costly and inappropriate for most borrowers. Research conducted for the Mortgage Bankers Association described stated-income loans as open invitations to fraudsters. These loans simply cannot be used for a homeowner on Social Security or for salaried workers whose income is readily established. They are directly contributing to foreclosures, as my last example shows.

We have a case in Brooklyn, New York, which alleges a property flipping conspiracy of real estate speculators, lenders, and appraisers and attorneys who sold our clients, all first-time homebuyers, damaged homes they had bought cheaply, cosmetically repaired, and rapidly resold at inflated prices. Our clients' six homes were overappraised by a total of $825,000.

How could low- to moderate-income homebuyers qualify for homes costing $300,000 to $400,000? Two were qualified using the NINA guidelines and a third using stated income that was inflated by the lender. As salaried employees and Social Security retirees, all had verifiable income, but the income was too modest to afford these loans. The homes would not have been sold nor would the mortgage origination and other fees have been generated if the verifiable income had been considered.

Piling on the risks, the lender put these folks into not one but two mortgages, which is commonly called "piggyback lending." The first mortgage provided 80 percent of the purchase price, and the second, a very high-rate mortgage, made up the balance. Again, while piggyback lending may make sense for some up-and-coming young lawyer, for our clients these piggyback NINA mortgages were a recipe for disaster.

Inability to repay is the hallmark of predatory lending. New and complex adjustable rate mortgages—the 2/28s, the 3/27s, the interest-only, option ARMs—all present their own affordability issues. Borrowers just do not understand them. They do not understand that they adjust up and never down, that if the borrower pays diligently each month, the mortgage balance will still go up because the payment is not even covering the accrued interest. Prepayment penalties of up to 5 years are the norm. Option ARMs are often promoted with 1-percent teaser rates that only apply to the first month of the loan. If lenders consider income at all, they typically underwrite at the initial teaser rate, not on the payments that will be charged once the loan fully amortizes, and certainly not on the maximum payment that might be charged.

These loans are a trap from which many homeowners never escape. Prepayment penalties make it impossible to refinance to avoid the payment shocks that are built into these loans. The trap has been fortified lately by the downturn in the housing prices. Homeowners who escaped foreclosure up to this point by refinancing will have no further recourse. When the equity is gone, the foreclosures will be inevitable.

While HOEPA drove out certain market abuses, others emerged. Our goal is to get ahead of this curve. Homeowners should not be caught in an endless game of Whack-A-Mole with the law constantly lagging behind the next wave of abuses. Our challenge is to address not only today's abuses, but to think comprehensively about how to make home mortgages safe and homeownership sustainable for decades to come.

AARP appreciates the Committee's work on this issue and looks forward to working with you.

Chairman DODD. Thank you very much, Ms. Davis.

Mr. Shelton.

STATEMENT OF HILARY SHELTON, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION FOR THE ADVANCEMENT OF COLORED PEOPLE

Mr. SHELTON. Thank you very much and good morning. I should mention my name is Hilary Shelton. I am Director of the NAACP's Washington Bureau. The Washington Bureau is the Federal legislative and national public policy arm of the Nation's oldest and largest grass-roots-based civil rights organization.

I would like to begin by first thanking my good friend, Chairman Dodd, and Ranking Member Shelby and the other Members of the Committee for holding this very crucial hearing. By holding the predatory lending subject as one of the first hearings held by this Committee in the 110th Congress, you are giving the attention to where it is well deserved. We look forward to working diligently with you until this issue is clearly addressed fully.

I am here today because predatory lending is unequivocally a major civil rights issue. As study after study have conclusively shown, predatory lenders target African Americans, Latinos, Asian and Pacific Islanders, Native Americans, the elderly, and women at such a disproportionate rate that the effects are devastating to not only individuals and families but whole communities as well.

Predatory lending stymies families' attempts at wealth building, ruins people's lives, and given the disproportionate number of minority homeowners who are targeted by predatory lenders, decimates whole communities. Traditional credit, high concentrations of subprime lending in predominantly racial and ethnic minority neighborhoods, and racial disparities in subprime lending exist in all regions of the Nation. And while not all subprime loans are predatory—indeed, the NAACP recognizes the benefits of the subprime market to a constituency which includes many without a strong traditional credit history—it is estimated that the vast majority of predatory loans are those with onerous fees and/or conditions exist in a subprime market.

A study put out last year by the Center for Responsible Lending demonstrated that for most types of subprime home loans, African Americans and Latino borrowers are more than 30 percent more likely to have higher-rate loans than Caucasian borrowers, even after accounting for differences in risk. Moreover, a study released just last month showed that high-income African American and Latino borrowers in the Boston area were 6 to 7 times more likely to have an expensive mortgage that Caucasians in the same income bracket in 2005. Given that Boston is most likely indicative of the rest of the Nation, this study clearly refutes arguments that subprime lending and predatory features are introduced solely across economic lines to mitigate risk.

It is important to recognize that almost 7 years ago, a study by the U.S. Department of Housing and Urban Development clearly demonstrated that many people of color could qualify for more affordable loans than they were receiving, which in turn would enable them to maintain and build additional wealth. In 1996, a study by Fannie Mae and Freddie Mac reported that as many as a third of the families who received subprime loans actually qualify for prime loans. Unfortunately, prime lending institutions continue to underserve people of color and whole communities occupied predominantly by racial and ethnic minorities.

Perhaps even more problematic is that, despite the fact that blatant racial bias and its debilitating effects have been clearly demonstrated and well documented, little has been done. The disparities continue. In fact, according to the most recent data available, in 2005 African Americans were 3.2 times more likely to receive a higher-cost subprime loan than our Caucasian counterparts, and Latinos were 2.7 times more likely to receive a higher-rate loan than white borrowers.

The bottom line is that predatory lending is making homeownership more costly for African Americans and other racial and ethnic minorities, as well as women and seniors, than whites and middle-class families. Given that homeownership is one of the most reliable ways for economically disadvantaged populations to close the wealth gap, one direct result of this unfair and immoral discriminatory practice is that it is harder for African Americans and other racial and ethnic minorities to build wealth or pass any material possessions on to their heirs.

Predatory lending is a direct attack on our financial security and economic future—an attack that is targeted at individuals and communities because of the color of our skin. I would like to take a moment to discuss with the Committee one type of predatory loan that has become increasingly worrisome as of late. Specifically, over 80 percent of the home loans made in subprime markets today are adjustable rate mortgages, ARMs loans, and the so-called 2/28s or 3/27 mortgages are the dominant product. This is important since over half the loans made by African Americans in 2005 and four out of ten made by Latino homeowners were subprime loans. Geographic concentrations of 2/28s in certain neighborhoods and communities of color have led to a spike in foreclosure and attendant community disinvestment.

Unlike most ARMs in the prime market, the short-term fixed rate on 2/28s and other similar loans is typically artificially low. When the loan adjusts after the initial 2-year period, subprime borrowers face enormous payment shock. Mortgage payment increases in typical 2/28 loans are up to over 50 percent monthly. Combined with other features of typical 2/28s such as prepayment penalties and the lack of escrows, 2/28S have the very real potential to place home borrowers in financial peril. Over the next 2 years, an estimated $600 billion in subprime mortgages will reset from the 2-year teaser rate. Too many borrowers, including an overrepresentation of African Americans and Latinos, will face a significant increase in their monthly payments. The impact this will have on whole neighborhoods and communities predominantly populated by African Americans, Latinos, and other racial and ethnic minority Americans will be nothing short of devastating.

A report issued last year by the Center for Responsible Lending estimated that one out of every five mortgages that originated during the last 2 years will end in foreclosure. To date, the Federal Government has been largely unattentive to the problems surrounding predatory lending, and, in fact, some of the rules and proposals we have seen in the last few years appear to go backward and take away some of the few protections we have gotten at the State level. This flies in the face of the NAACP's belief that the primary responsibility of Government, to protect its citizens, all of its citizens, not to exploit them or allow them to be exploited at the gains of just a few.

As our elected representatives, the NAACP calls on Congress to enact an aggressive and effective Federal law and to soundly reject attempts at addressing predatory lending that will not resolve the underlying problem and will, in fact, roll back the few protections that a few States have put in place.

Because I have been asked to speak today on behalf of the national civil rights community, I would like permission to include in the record three documents which are attached to my written testimony. The first two are both prepared by the Fair Housing Subcommittee of the Leadership Conference on Civil Rights, of which the NAACP is a proud member and a founder. The first article outlines our position on Federal predatory lending legislation and outlines some elements that we consider to be essential in any effective proposal. The second paper expands on our concerns about 2/28s and other exploding ARMs. The last attachment is a letter that was sent just this morning to Chairman Dodd and Ranking Member Shelby, as well as the Chairman and Ranking Member of the House Banking Committee. This letter was signed by approximately 200 national, State, civil rights, and consumer and housing rights groups, including the NAACP, and it lays out some of our primary goals in any anti-predatory lending legislation.

I want to thank you again, Chairman Dodd and Members of the Committee, for holding this hearing and taking the time today to take a serious look at a very real problem associated with predatory lending. As I mentioned earlier, the NAACP stands ready to work with you on aggressive, comprehensive legislation to address this very real civil rights scourge in our Nation.

Chairman DODD. Thank you very, very much, and those documents will be included in the record.

Mr. Duncan, thank you for being here. Doctor, we appreciate your presence.

STATEMENT OF DOUGLAS G. DUNCAN, SENIOR VICE PRESIDENT OF RESEARCH AND BUSINESS DEVELOPMENT, AND CHIEF ECONOMIST, MORTGAGE BANKERS ASSOCIATION

Mr. DUNCAN. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, my name is Doug Duncan. I am the Mortgage Bankers Association's chief economist and Senior Vice President of Research and Business Development. Thank you for the opportunity to testify here today as you review and consider the issues of predatory lending and foreclosure.

The real estate finance industry is proud of its record of providing homeownership opportunities. MBA's members have been a driving force in establishing communities, creating financial stability and wealth for consumers, and fueling the overall economy. Our industry has played a major role in facilitating a near–70–percent homeownership rate, a benefit to all of us. However, we understand some are concerned about several of the newer mortgage products, and recent increases in delinquency and foreclosure rates.

MBA believes that there are three things the Government can do to help protect consumers:

First, make financial education a priority, empowering consumers with knowledge and giving them the tools they need to make good decisions and protect themselves.

Second, simplify and make more transparent the mortgage process so consumers may better understand the details of what can be a complicated transaction and facilitate shopping more efficiently from lender to lender.

Third, enact a strong and balanced uniform national standard for mortgage lending within increased consumer protections.

The mortgage industry has been extremely innovative in developing products and financing tools to create homeownership opportunities, expand affordability, and facilitate greater consumer choice. These have been especially important as housing costs have risen over the past several years.

The industry's record over the last decade is one of particular pride. We have helped bring enormous financial sums to bear to expand liquidity and invest in communities. Recently, however, there have been claims that these very products and financing tools are themselves bad for consumers and have driven foreclosure rates to a state of crisis.

MBA does not accept the suggestion that foreclosure rates are at crisis levels or that lenders or loan products are driving foreclosures. To the contrary, MBA's well-respected data on foreclosure rates show that they are well below the levels of their post-recession peaks. Further, we believe that these very products and financing tools have helped our neediest borrowers. If policies were adopted to limit or eliminate these financing tools, it could be detrimental to those underserved borrowers who now have access to affordable mortgage credit.

Research from MBA and others consistently finds that foreclosures today occur for the same reasons that they have always occurred, namely, unexpected shocks to a family's finances: job loss, divorce, and illness, which continue to be the main reasons for defaults and foreclosures. The data do not support assertions that products have created a foreclosure crisis.

In order to address the problem that some families may not completely understand all the details of the mortgage products they receive, some seek new rigid underwriting standards and the imposition of suitability requirements. MBA strongly believes these approaches, which may look reasonable at first, will simply stifle innovation and rob consumers of affordable financing options, thereby severely limiting consumer choice. Proposals that would reinject subjectivity into an objective underwriting process we have worked so hard to develop risk turning back the clock on impressive homeownership and fair lending gains. Before we pursue any of these proposals, we must be sure that they do not undermine our mutual goal of putting Americans in homes and keeping them there.

We do not agree with those who would stem innovation by removing products from the market because they do not think they are good for borrowers. The plain facts are that these products have brought homeownership to many borrowers who probably could not have achieved it otherwise. And as a corollary, we wholeheartedly reject the notion that some borrowers should not have these affordability options to become homeowners and build the wealth that homeownership brings.

Instead of limiting choices, I repeat what I said earlier. MBA believes efforts should be directed toward new and increased efforts to provide national financial literacy training, make the process more transparent, and establish a uniform national standard to protect consumers and provide certainty to financial institutions. It is too easy to blame lenders or loan products. The harder work is to solve these complex issue. MBA is committed to working together with you and other organizations in this important effort.

Thank you, and we look forward to your questions.

Chairman DODD. Thank you, Doctor.

Mr. Eakes, thank you for being here.

STATEMENT OF MARTIN EAKES, CHIEF EXECUTIVE OFFICER, SELF-HELP CREDIT UNION AND THE CENTER FOR RESPONSIBLE LENDING

Mr. EAKES. Good morning. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for holding this hearing. I really appreciate it.

I head an organization called Self-Help that is a community development lender based in North Carolina. I also head the Center for Responsible Lending, a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership.

Self-Help, with about $1 billion in assets, is one of the largest nonprofit homeownership lenders in the Nation, which makes us about the size of one Bank of America branch, to give you some perspective. We are a lender. We have been a subprime lender since 1984, over 20 years. In the beginning, we made thousands of loans to mostly African American, single mothers. In our first 10 years, we had not one single foreclosure or loss.

In the last 20 years, we have provided close to $4.5 billion to 45,000 homeowners across the country in 48 States. We have had very few foreclosures and losses during that time. I can say as a matter of experience that if a lender has very high foreclosures and loss, they are doing something wrong. The lender is doing something wrong. It is not the borrower to blame.

Home lending, however, has changed a lot in the last 20 years since I have been active. It used to be that a local bank or savings and loan would make a home loan to a borrower, and they would hold that loan on their books until it was paid off. If the lender made a bad loan, the loss would be suffered by both the lender and by the borrower. In essence, they were both in the same boat together.

Today, 70 percent of subprime loans are made by mortgage brokers who never own the loan and who place the loan with a lender who holds it for 1 to 2 months before it is then transferred to a securitization vehicle, and then sold to investors worldwide. So long as the loans do not default immediately, within the first 3 months, the broker and the lender do not have any financial responsibility for the loan if it goes bad down the road.

Brokers and subprime lenders are not bad people, but their financial incentives are different than what we saw just 20 years ago. Now their financial incentives are to close as many loans as possible, as fast as possible, regardless of risk. Whether the borrower can repay the loan, so long as it lasts for at least 3 months, is really not of their financial concern.

We really do have a foreclosure crisis in the subprime mortgage marketplace today. I will not repeat the studies that were cited earlier by Friedman Billings, USB, Bloomberg, Moody's, everyone who says that the subprime loans made in 2006 will have a foreclosure rate higher than any other mortgage cohort of loans in history.

In December of 2006, my organization, the Center for Responsible Lending, issued one of the most comprehensive foreclosure studies ever. We looked at 6 million subprime loans at the loan level where we had fees and data—foreclosure, FICO scores, all of the data around 6 million subprime loans made between 1998 and 2004. The conclusion that one out of five loans made in the subprime marketplace in 2005 and 2006 will end in foreclosure or the loss of a home has generated a lot of controversy, but I will tell you I am 100 percent certain that that number is understated for the following reasons:

No. 1, it does not include the loans that have what I call a distressed prepayment, loans that were already delinquent by 30 days or more that then paid off. They did not go to a prime mortgage if they were already delinquent. That is another 11 percent of this group, so it goes from 20 to 30.

The second thing it does not do is we looked solely at a cohort of loans in a given year, and most of the borrowers in the subprime arena get refinanced. unnecessarily in many cases, every 18 months. So that if you look at this from a borrower's point of view, they had a one in five chance of being foreclosed in their original loan. They have a one in five chance of being foreclosed in the second loan that they got into 18 months later. And it ends up, if you carry that cycle of repeated refinancings, that the foreclosure rate of borrowers, not of the loans in a particular year, can be as much as 30 or 40 percent of the total.

I will not repeat all the same numbers, but let me give you a new one. The subprime outstanding mortgage loans today represent about 13 percent of total outstanding mortgage loans in the United States. That 13 percent represent, as of the end of 2006, 60 percent of all foreclosures started in this Nation. So think about that: 13 percent of the loans represent 60 percent, and the remaining 87 percent of prime loans represent the remaining 40 percent. So this small segment—it is not that those families have more death, divorce, illness, and job loss. That is just not the factor. The factor is that the product itself is dangerous.

I did not choose to get into this work. I am a lender. I would like to be helping people own homes. That is what I do best. But I grew up in an all-black community as a child. My friends were destroyed growing up. My best friend was killed on a playground behind my house. And I pretty much promised at that time that I would do in the future what my young friend did at that time. And I feel like right now the crisis that we face, particularly in African American communities, is unbelievable.

You may not know this fact, but the 50 percent of families, African American families that do not own homes, do not have any net positive wealth at all. Their wealth in the household is either zero or negative. So the wealth that black families have is in the 49 percent that own their homes. Fifty-two percent of all African American mortgage loans in the last year—in the last 2 years were subprime mortgages that are, by structure, impossible to succeed in. So I look at it and I say the families—the African American families that have the wealth in this country, half of them are in danger of losing their homes. Subprime foreclosures threaten to displace more African American families than did Katrina. But it will be a silent and invisible storm that hits this time—one family at a time, one neighborhood after another, all across America. We have the greatest threat to minority wealth, family wealth that we have ever had in the history of the Nation.

The citation comes up of saying, well, if one in five foreclose, that means the other 80 percent succeeded, right? Aren't we really helping through this product more families, particularly families distressed and of color, become homeowners? And, sadly, the answer is no to that.

The first fact, which, again, is not always featured. Eleven percent of the subprime loans are to first-time homeowners. Eleven percent. This is in Mr. Duncan's testimony. What that means is the remaining 89 percent already have a home that they are either refinancing or they are moving and by getting a subprime loan are putting that home in danger.

So just do the numbers a little bit. If we say for 11 percent—let's be generous and say 9 percent of those got home loans that they could not have gotten anywhere else and that they will succeed with them, what that means is then the foreclosures that happen on the remaining 87 percent, 20 percent of them will far outweigh the potential gain from the small number that get their first-time home there.

So let me be clear. I am not seeking to abolish the subprime mortgage market. I am part of it, have been for 20 years. What I am requesting is that this Committee take five steps.

First, impose an ability-to-repay standard for all subprime loans. The trap that people are caught in now where they have a loan—and 70 percent of subprime loans are 2/28s. You have a 2–year fixed-rate period. The remaining 28 years are adjustable rate every 6 months. A typical loan will have a very high margin so that the adjustment will jump to as high as 11 or 12 percent during the third year of the loan. So here is the dilemma that a borrower faces. Either they pay off the loan before the 2 years—in which case they pay a prepayment penalty in virtually every case which is equal to 3 percent of the loan amount; 3 percent of a $200,000 average subprime loan would be $6,000. That is more than the average African American wealth in the last census period. So either you pay off early and you lose your downpayment and the equity that you have built up, or you wait until the 25th month, and all of a sudden your payment has jumped by 30 to 50 percent, and you cannot make the payment, you are foreclosed, or you are refinanced into another loan with another set of fees. It is a devil's choice, and it is one that is set up that will create foreclosure.

The second thing is require mortgage brokers to have a fiduciary duty to the borrower they represent, just like doctors, lawyers, stockbrokers, and realtors have a fiduciary duty of loyalty and care to their customers. It is just early in the process.

Third, require the regulators to clean up these abuses, and particularly I want to focus on the Federal Reserve for a moment. In my testimony, I cite on page 19 a section of HOEPA in 1994, which reads as follows—I am going to read it because it is that important.

It says, "The Board, by regulation or order, shall prohibit acts or practices in connection with mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this Section." It does not say just high-cost loans. It says any practice in the mortgage marketplace that the Board finds to be unfair or deceptive, that the Federal Reserve Board shall prohibit acts or practices. Since 1994, the Federal Reserve Board has not used this authority a single time, even though we have had rampant abuses during this time period.

As Chairman Leach said in a 2001 hearing, we wouldn't have these problems if the Federal Reserve had simply done its job. But it has not done its duty under this statute. There are actions that can be taken.

No. 4, as mentioned before, we should prohibit Fannie Mae and Freddie Mac from getting homeownership goals credit for buying securities that have loans that do not meet an ability-to-repay standard. They should not be getting credit for loans that come through the back door where they did not do any of the work to produce the loans. They take no risk in them because these are AAA securities. And it is furthering and financing the sector that is causing such distress in African American and Latino neighborhoods.

Finally, No. 5, please pass a strong national anti-predatory lending law that establishes a minimum floor for what it means to have responsible lending.

Thank you very much.

Chairman DODD. Thank you, Mr. Eakes, very, very much. Very compelling testimony, and we thank you for your work. And I think all of us here agree with the underlying point. There is a danger in conversations like this that people will use the word "subprime" and "predatory" as synonyms, interchangeable words, and they are not at all. And I hope it is clear to everyone here. Certainly those who are knowledgeable about this understand this already, but for those who are hearing about these issues for the first time, there is a danger that those of us who are interested in the subject matter would confuse the word "predatory" with "subprime." And you have made it very clear, Mr. Eakes, and certainly Reverend Jackson has and others. And I believe that very strongly as well. This has been a tremendously valuable vehicle, the subprime process for people who want to have homeownership, want to own their own home.

I want to begin my questions by emphasizing that point and the value of homeownership and what it means for our economy. So we begin the discussion there.

We have been joined by our colleague from Florida, Senator Martinez, and you were not here earlier, but, in fact, Hilary Shelton mentioned 7 years ago something that HUD did, and I know that the person who was responsible for taking a hard look at this issue was the Secretary of HUD at the time, our colleague from Florida, Mel Martinez, who deserves a great deal of credit as HUD Secretary for looking at these issues. And he brings real knowledge to these issues given his previous life at the Housing and Urban Development agency. So we are pleased to have you with us this morning, Mel.

Senator MARTINEZ. Mr. Chairman, thank you very much. Sorry I could not be here at the beginning of the hearing, but I appreciate the mention. I have developed a great interest in this topic when I was at HUD. Anyway, I will wait my turn, but I appreciate your mention.

Chairman DODD. Let me begin with you, Reverend Jackson, and thank you immensely again for joining us here today. You have traveled throughout the country. You have seen the results of where discrimination can occur. You have listened to the testimony here this morning. Give us a sense of what it means in a community when you have long-time homeowners who are forced into foreclosure. I tried to say it, but I am not sure I did it very eloquently, the idea of this ripple effect. Just as homeownership in a neighborhood and community has the positive effect of creating stability, increasing home values, all of the proper things we like to see associated with homeownership, when that begins to collapse, what are the effects as well? I wonder if you might speak to that.

Reverend JACKSON. Well, first, this is targeted economic exploitation. This is not accidental nor incidental. This is targeted. And it is not only racial targeting, though that is very well documented. In the end, the vultures go after whoever is the most vulnerable, and it may be a black person or a brown person or a senior or a soldier. Ultimately, they do not stop unless protected by law.

One place I find to be a painful sight to see, the lenders, the cashiers, lining up outside the military bases. The soldiers that have to go to war and leave their families in a financial trap, and some of the most exploited people in the whole process are the spouses of soldiers in Iraq and Afghanistan. Or take a trip down to Appalachia, if you will. And so while there is this racial disparity dimension, the greedy ultimately go blind in their pursuit of exploiting whoever is vulnerable.

Second is that the bank is the first line of defense, and if the bank drops their line of defense, the quarterback then cannot function. And when the banks finance the predators, you go to the front door of the bank, and they say you are not eligible because your record has not been expunged, you are not eligible because you have a low credit score, and so you cannot get 7 percent, they go to the predator, who we finance at 25 percent.

So the bank is making money off of both ends, and whatever they do on the good side, on the CRA, they more than offset it with their back-door bank, which is, in fact, the predator. And to me, nothing short of the Senate passing strong laws to protect the vulnerable. And I have people say you learn how to read—you cannot learn how to read these slick people. I do not care how literate you are. You cannot think through this. My grandmother used to borrow $11 and pay back $33. She could not read. She was not expert in them. She could not read. She could not write. She was not very smart. She was trying to take care of her children. She was taken advantage of by pawnshops and by these lenders. And so without the protection of law, the people cannot protect themselves. And right now I am not convinced that that law is there.

And I would like to make the last point that at some point the Department of Justice has a role in this. People's basic civil rights—I was in Louisiana and watched them sell a blind woman a bigger TV screen. I mean, they are ruthless in the exploitation, and since this document, the question after we testify today then for Mrs. King, what can happen to her in Chicago when they can profit $600 million off of home foreclosures.

I guess the point that strikes me the most, Mr. Martinez, is that I was in Detroit about 2 months ago, and Ford announced they were laying off or dismissing 55,000 workers. And for Detroit and Dearborn, what does that mean? It is going to be a payout, they called it, or a put-out.

When Honda and Toyota can build in our country and Ford cannot build in Japan and South Korea, what does the unfair trade deal mean: Fifty-five thousand people whose homes are going to go up for grabs, who cannot pay their house note, whose children will come out of college, who cannot pay the drycleaners, who cannot pay the local hotels built around the Ford plant. The spinning impact of—I mean, you talk about a tsunami, a bomb dropping on Dearborn, Detroit, and Youngstown, you lose 55,000 jobs in the industry and the spinoffs, and it seemed to me to be, Senator Shelby, no safety net for those workers who, through no fault of their own, lost their jobs to trade policies far beyond them.

There must be some—and for our allies abroad, we have safety nets. That is what OPIC—Overseas Private Investment Corporation, Government-private partnerships. Or we have for them a Marshall Plan with long-term, low-interest loans on behalf of the soldier after World War II, some call it GI Bill. They get some differential and, you know, $51 billion will be spent. The biggest boost to homeownership was the GI Bill, which, by the way, was an affirmative action program for soldiers.

But it seems I am asking you to think of something outside of the present box, the OPIC, the GI Bill differential. Something outside of the present box must be devised because the conventional lender will not loan, the predator will cost too much, and there must be something in the middle, some kind of development bank that takes into account these new realities. We are going to have the reality of exporting jobs and importing product. We were exporting product and importing job. That dynamic shift has left a whole lot of American people of whatever race trapped in the cross fire.

Chairman DODD. Well, thank you very much, Reverend, for that. Let me ask one more question, if I may, and I would like to raise this with Mr. Dinham, if I can, and Mr. Duncan.

Mr. Dinham, I was struck that in your testimony, Appendix A, you talk about an issue that was raised by Mr. Eakes, and that is the relationship between the mortgage broker and the borrower and that this is an independent contractor with really no fiduciary responsibility to the borrower. In fact, you speak about it here, the language in your testimony here. You make exactly that point, that they are independent contractors not responsible to the borrower.

Yet in advertising materials and reports that we get from consumers, news reports, brokers often seem to market themselves to borrowers on the basis that they will shop for the borrower in many ways, and that is, the broker leads the client to believe that he or she acts on behalf of the borrower. You heard that, I think, in the testimony both of Ms. King and Ms. Womble, that that person on the other end of the phone you were dealing with here was really your advisor in a sense, and certainly creating that sense that I am in this with you, I am here to help you to work through your difficulties.

And, again, I am not suggesting that anyone there is not going to necessarily be so objective that they would not try to appeal to someone they are trying to do business with, but that clear impression, particularly for people—and I listened to two people here who are rather sophisticated—homeowners, in business. We are not talking about people here who were not knowledgeable about finance and so forth being victimized by this. So we have a tendency to talk about the unsophisticated. These were fairly sophisticated people, I might add, who have been pretty careful about their lives, have been productive citizens, contributed significantly to their communities, and yet were dealing on the phone with someone who made them feel clearly that they were acting in an advisory capacity. In fact, observers credit the success of the mortgage brokers industry to the ability to convince people. I was looking—let me quote from a newsletter called Inside B&C Lending, and hardly a liberal mouthpiece here. But in an article from June 9th of last year called "Brokers"—and I am quoting, "Brokers still the main engine for origination of subprime loans." The author writes, and I quote him, "Brokers have proven adept at marketing their services to borrowers, often playing the role of trusted advisor."

So even if not the intent, the clear marketing, at least in that publication, suggests that, in fact, that is how the broker ought to hold themselves out, as the trusted advisor.

So my question is: Do you believe that brokers either are or market themselves as trusted advisors of the borrower in your experience?

Mr. DINHAM. In my experience, no, we actually don't as a trusted advisor. What we do is we have a—the thing we offer is the consumer choice along with several different types of products, and the normal procedure would be that we would come up with like three products and saying this product is good for this, this product is good for that, this policy is good for that.

So what we are is a funnel which we are able to offer the consumer a lot of choices as to which way he wants to go at that point. And we are real big on trying to help him pick the loan that he thinks is best for him.

Chairman DODD. But not as the trusted advisor?

Mr. DINHAM. No, sir, not in a fiduciary capacity because we do not have every product that is in the marketplace. So we could not absolutely offer him the best deal that was in the market at that point. We can offer him the products that we have, but not the best deal in the market.

Chairman DODD. Let me ask you, because I appreciate your answer to that, but we went and looked on the website of the National Association of Mortgage Brokers under the "Frequently Asked Questions" section of the website. The very first question is: "Why choose a mortgage broker?"

The answer given on the website is as follows, and let me quote it to you: "The consumer receives an expert mentor through the complex mortgage lending process." Now, if you look up the word "mentor," and anyplace I looked it up before, a mentor is oftentimes described as a "wise and trusted counselor or teacher."

So even on the website of the National Association in the most frequently asked questions, the advice to the mortgage broker is hold yourself out as a mentor in a sense. So you are holding yourself out—how can you be a mentor, an advisor, and at the same time be that independent contractor? It seems to me you have got a conflict here in promoting this.

Mr. DINHAM. Well, I think that maybe we do have a conflict there ta this point, but I think what we are trying to say there is that we offer a lot of—we offer the consumer a lot of choice at that point, and that is what we are doing. We can put a deal together for him that he cannot get normally somewhere else at some other point.

Chairman DODD. How do you answer the question here? What happened in the case of these two women? What would your response be if they were to ask you, how did it end up that someone could give loans under these circumstances to these two women? You have heard their testimony, what circumstances they are in, the incomes that were coming in. How could that possibly happen that someone would extend the kind of loans to these two individuals given their fixed income in the case of Ms. King and the circumstance that Ms. Womble was under? How does that happen?

Mr. DINHAM. Well, in listening to Mrs. King's story, I got the impression that she wasn't fully disclosed on the front end of the loan, what the loan would do in the beginning at that point.

Chairman DODD. She should have been, shouldn't she?

Mr. DINHAM. She should have been. And, you know, we are trying to get to that point. You know, one of the biggest problems we have today is the truth in lending process and the good-faith estimate process, because there is no correlation or no required correlation between the good-faith estimate that you give at application and what you get at closing. It has been a big problem for a long time. It needs to be fixed.

We would also like to see that on these types of loans—and on every type of loan—that we get to a disclosure on the truth in lending. The truth in lending is woefully inadequate also because it only goes to the first 3 years of an adjustable rate mortgage.

So from my perspective, we need to fix the truth in lending process so that the consumer has a full understanding in the beginning of the loan they are getting.

Chairman DODD. Senator Shelby.

Senator SHELBY. Thank you.

Ms. King, Ms. Womble, Ms. Davis, you have given us examples of some tough, disastrous situations, and I believe you are only touching the tip of the iceberg here. In our marketplace, there should not be any place for fraud and exploitation. It sounds to me like some of your situations with the facts you have told are probably fraud, civil and perhaps criminal.

Risk-based pricing has, as we all know, brought a lot of good things to the marketplace. It has brought credit, but it has also brought problems. We need to eradicate that the best we can.

Mr. Chairman, I hope that under your leadership we can get the regulators up here following this hearing today.

Chairman DODD. We will.

Senator SHELBY. And see what the Federal Reserve and others are doing in this area, because I think it is very, very important, whether it is in Illinois, North Carolina, my State of Alabama, Oregon, or wherever. These kinds of situations will destroy our risk-based credit system, and we do not want to do that.

Reverend Jackson and Ms. Davis, I want to get into a question. Fannie Mae and Freddie Mac remain the largest purchasers of subprime, private-label, mortgage-backed securities. A lot of these securities are AAA grade, yet the foreclosures are there, the risk is there. And we know that. We have dealt with the GSEs up here before, and I am sure, Mr. Chairman, we will deal with them again.

What extent do you believe, Reverend Jackson, that the secondary market, Freddie Mac and Fannie Mae, are providing funding for some like the subprime and predatory mortgage lending, what is their role here? It seems to me like that is not always a good role.

Reverend JACKSON. Well, for the most part it is, except——

Senator SHELBY. I know it is, but not always.

Reverend JACKSON. Of course, not always. I think they must be challenged to honor the ability-to-repay standard. Maybe second only to banks is that they are under a kind of oversight, unlike the other predators—other predators, should I say, maybe the subprimes are under less oversight.

What protects the people ultimately is enforced law, adequate and enforced law. And much of what is happening to Ms. Womble and Ms. King is unenforced law. And, again, the point I made was that for many whites, for example, they have banks and they have access to neighborhood banks or branch banks. We are almost sent off immediately to the wolves, the unprotected. The big finance, you know, they get CRA, so that can be some better lending. But we are quick to be turned down at the front door, from expunging of records to credit score, and then sent to the economic wolves.

Our appeal to you is I think Ms. Womble and Ms. King give you examples, and Ms. Davis, of what is happening in the marketplace. What can we get from you to protect us from this kind of exploitation?

Senator SHELBY. Ms. Davis, the ability to pay seems just to make a lot of sense on any loan anybody makes. And like Ms. King was talking about, and Ms. Womble, it was taking just about every cent they had to make a payment.

Now, one loan characteristic that has been talked about that is described as predatory is the practice of making a loan without regard, it seems, to the borrower's ability to repay the loan. That has not always been the case.

Ms. CONSTANTINE-DAVIS. No. That is right.

Senator SHELBY. Now, do you want to comment on that? Is that troubling to you?

Ms. CONSTANTINE-DAVIS. Frankly, in the course of preparing to be here today and in conversations with other consumer advocates, I could not help but, you know, think to myself how far we have come if we are talking about passing a law that says that lenders cannot make loans to people that they cannot afford. This used to be second nature. It was something we all took for granted, that this was the only responsible way for both parties to proceed. And at this point that is just not the case.

Reverend JACKSON. Mr. Shelby, what I was also trying to say is that when you go to the bank, the bank is held to a higher standard to do what Ms. Davis is saying. When the bank immediately kicks us out the back door to the wolves, it is the unprotected area that runs amok.

Senator SHELBY. Sure.

Reverend JACKSON. And where the banks cannot get off is that they finance the wolves. They are partners in the process. The banker still maintains his blue-striped suit up front, but he is financing the wolves that live back here and has dirty clothes. But the dirty-clothes guy is funded by, you know, the striped-suit guy. And, therefore, the oversight protection cannot stop just at the bank and CRA and the securitizer.

Senator SHELBY. Well, if the wolves originate, for example, some of these predatory loans, some of the loans that are fraught with fraud or close to it, if not that, exploitation, and they dress them up and they put a little coat on them, and then they——

Reverend JACKSON. A wolf in sheep's clothing.

Senator SHELBY [continuing]. Sell it in the secondary market and so forth, and they say, by gosh, this is a triple-A grade security. Is that right, Mr. Eakes?

Mr. EAKES. Right.

Senator SHELBY. Is that what happens?

Mr. EAKES. Yes. I mean, Fannie Mae and Freddie Mac in 2001 were enormously helpful to all of us on some of the—on first wave of predatory lending standards, like prepayment penalties, limiting, getting rid of single-premium credit insurance. And now really what I feel like is a failure of moral leadership, that they need to be stepping out in this area that is causing so much danger. The truth is that if they stop investing, the 25 percent of subprime securities that Fannie and Freddie buy, perhaps $150 billion a year, that is a big number. But the marketplace would step in for them. The problem from my viewpoint is that if they would step out and help—you know, just implement the ability-to-repay standards, the limits on prepayment penalties, the limits that they have in the normal course of business—

Senator SHELBY. They could do a lot more than they are doing, couldn't they?

Mr. EAKES. They could. They should.

Senator SHELBY. And at the end of the day we all know they are a Government-sponsored enterprise, GSE, with the implicit guarantee of the taxpayer when they sell those securities. Is that correct?

Mr. EAKES. Yes.

Reverend JACKSON. Senator, our interest is not in trying to destroy Freddie Mac and Fannie Mae or the banks.

Senator SHELBY. Me either.

Reverend JACKSON. But maybe all the forces involved should be around a common table. Let Freddie Mac and Fannie Mae make their best case and the bank make their best case and the mortgage lenders. It seems that when they resolve this in sessions where each group is arguing “it ain’t me, it’s them,” arguing for advantage, because on the best day the banks and Freddie Mac and Fannie Mae work. But in the last several years, it is beginning to unravel, and there needs to be some mediation or some reconciliation. I don’t think—some of this is intentional, but I think some of this broker business is just absolutely exploiting the gap.

Senator SHELBY. I agree with you. We have a good financial availability of credit system in the U.S., but it is kind of like a hamper of beautiful apples that comes in, and there is a rotten one there, and it will contaminate the whole bucket or bushel of apples if we do not do something about it. Don’t you agree?

Reverend JACKSON. Yes, I agree, except it is more than one apple.

[Laughter.]

Senator SHELBY. Well, it is already spreading. More than one rotten apple, but the idea of at least one, maybe more rotten apples in the bushel is there. But a lot of good stuff is there, you point out, too.

Reverend JACKSON. In our neighborhood, when the banks come with the branch banking and do their job, people are protected. And Freddie Mac and Fannie Mae do theirs. But now what we see coming, as the jobs leave, taxes go up, services go down, and in come payday lenders and cashiers. It is like they sense that, they smell blood. And as the taxes go up and the jobs leave and the foreclosure comes in, they seize the market. And we need you to help take away the incentive for the banks to leave and for the predators to come.

Chairman DODD. It is a lack of balance, is what you are talking about here.

Reverend JACKSON. No balance.

Senator SHELBY. We do not need the wolves running in our neighborhood, do we?

Reverend JACKSON. Right.

Chairman DODD. We could probably pick out another fruit at some point, too.

[Laughter.]

Senator SHELBY. No, I think the apple——

Chairman DODD. The apple industry is——

Senator SHELBY. I said one apple, and he says more than one, and we do not have a big disagreement there.

Chairman DODD. Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman.

Mr. DINHAM, I WANT TO DIRECT MY FIRST QUESTION TO YOU. I do not think anybody can disagree with the fact that, as we listen to the stories that people like Ms. King and Ms. Womble bring to us, we ask ourselves: How could that happen? How could we have a system of credit in this country in which this kind of abuse occurs legally?

The question I have for you is: What kind of market discipline is there in the subprime lending market today? We are talking here, I assume, in this hearing and in further deliberations about what we may need to do to add some market discipline. What do we have today? And how do these kinds of things happen?

Mr. DINHAM. All I can do, I can relate back to in the middle 1980's in Houston, Texas, when they had the oil bust down there. During that period of time, there had been a lot of 95–percent loans made in certain subdivisions down there. These were not subprime loans, but this was—the market had just gone sour.

What happened was that they came back—the MI companies that were insuring their proportion of those loans came back and told them that they were not going to make any more 95–percent loans and they probably would not make any more 90's in those areas until the market straightened out.

So, you know, I have always been a market philosopher type at that point, and I really believe that if these loans continue to create too many foreclosures or defaults, they will go away. Since 1980, we have had all sorts of products come through, adjustable rates. We had no adjustable rates before 1980. But ever since then, they have come through, and they have come and gone, depending on whether they were not liked, whether they cost too much for the lender, because every time that we—not we, but the lenders foreclosed on a loan, it is going to cost them some money at that point. So they do not want them either at that point. They do not want the loans back.

So to me, the market will correct in the end.

Senator CRAPO. You have raised a very interesting point here. Let's take the case of a circumstance like Ms. King described to us. If her loan goes into default, has the mortgage broker profited regardless? Or has the lender profited regardless of what happens to her?

Mr. DINHAM. Not in all cases, because it depends on how your contract reads with whoever the lender is in that particular case. If there was a profit involved in that particular thing, they would probably charge you back that profit if it was in a certain period of time. It just depends. Different lenders have different requirements on what they will do at this point.

Mr. EAKES. But 99 percent of the loans, the broker or the originator who did not hold the loan have gotten their profit and do not get put back. So only if it defaults within the first 3 to 6 months is there, by the investors, a liability put back on the lender. And after that time, it is very, very rare for any kind of liability to be put back on——

Senator CRAPO. So if I understand you correctly, there is a profit incentive to make a bad loan like this if the loan can survive for a period of months.

Mr. EAKES. Three months.

Senator CRAPO. Mr. Duncan, do you want to comment on that?

Mr. DUNCAN. Yes, I would. I would like to differentiate a little bit between terms and then describe recent events which give evidence of the disciplines that are in the marketplace.

First of all, the lender is the company that comes to the table with funding. Typically, large lenders will have several different channels of production, one of those being through brokers who bring them loan applications, which they can either agree or not agree to fund.

To the extent that those loans are securitized, they are packaged, held for a period, and then sold into the secondary market. And the investors to whom they sell them establish a contractual agreement with them about the period of time in which early payment defaults, which, if they occur outside of the investor's tolerance, will be put back for purchase. That is typically longer than 3 months. It is more in the 6- to 12–month timeframe, so that you can see that the borrower has established the repayment capability that was anticipated in the application.

Recently, you have seen three or four subprime lenders who put loans to Wall Street which did not meet those criteria have to buy back sufficient loans that they were put out of business. So the market does have a mechanism for disciplining lenders who make loans that are not sustainable by borrowers. In fact, it puts them out of business. Ownit, Mortgage Lenders Network, Sebring Capital—these are all firms that have failed in the last 6 months because of required buybacks.

In addition, you recently saw Frema Mortgage terminate relationships with over 8,000 brokers who they believed to be delivering to them loans which did not meet the criteria that they would have to continue to support to provide collateral for asset-backed securities.

Typically, what lenders do is they will run a scorecard on each broker, and that scorecard contains a series of measures about the quality of loans that are brought in for ultimate delivery to investors. If they do not meet the scorecard minimums, they are terminated from the system

One of the problems is when you identify bad actors, there is not a national registry that allows for cataloguing of bad actors, no matter who they are, that you can prevent them from going from one market to another, and that——

Senator CRAPO. When you say one market to another, you mean one lender to another?

Mr. DUNCAN. Certainly, they can do that, too. They can move it—they may be headquartered in Phoenix and move to Arkansas, and you would not know that because there is not a registry that would identify them.

Reverend JACKSON. We chase down sex predators. Sex predators, we chase them State to State.

Can I just add one thing? When Ms. Womble and Ms. King go home today, they are facing foreclosure. Is the problem that there is something wrong with them or did somebody violate a law? Did somebody break the law on them?

Mr. DUNCAN. We would be happy to—particularly in Ms. Womble's case, it sounds to use, from what we have heard here this morning, that fraud has been committed both against her and against the lender, and laws exist to prosecute that fraud. And we would fully support funding to enable the appropriate regulators to prosecute that.

Mr. EAKES. The problem with waiting for the market to correct—and it is correcting right now. There is no question that the investors are now on guard, having the same interest that borrowers now have, saying we do not want to take losses in this environment where property prices are not appreciating.

The problem with that is that the market correction has a lag of several years, and so when Ownit, the company just mentioned, went out of business, it was in no way able to reimburse the tens of thousands of borrowers who go into loans that were foreclosed. It just went out of existence. And so, yes, the business is gone, but the 2 million families that are in loans that will be foreclosed upon get no relief from that market correction. And that is the severe danger of thinking that the market by itself will be sufficient.

Senator CRAPO. Mr. Chairman, if I could just follow this up with one more question.

Chairman DODD. Sure.

Senator CRAPO. It seems to me from what we are hearing in this line of questioning is that there is a market discipline in place, it is working, but there is a question raised as to whether it works fast enough to not leave too much damage in its wake.

Chairman DODD. People like these two women here.

Senator CRAPO. As the market operates, and we have examples here of Ms. King and Ms. Womble.

I guess I would just like to ask you, Mr. Duncan, if you could comment on that point that was made by Mr. Eakes, that the market corrections—or the market discipline that we already have in place is not working fast enough.

Chairman DODD. Can I add on to the question as well? These numbers we have been talking about, I mentioned them in the opening statement, 1.2 million, 2.2 million foreclosures in the next year or so here. I would like to give you a chance to comment on those numbers as well.

Mr. DUNCAN. Certainly.

Chairman DODD. That is the number that is estimated.

Mr. DUNCAN. Certainly. We have a broadly available public data set on delinquencies, which we have—delinquencies and foreclosures, which we have published since 1972 on a quarterly basis. It contains about 43 million loans out of the estimated 50 million loans that are outstanding in the U.S., of which within those 42 or 43 million loans are about 6 million subprime loans.

At present, the foreclosure percentage—that is, the percent of all those loans that are somewhere in the process of foreclosure—is 1.05 percent. So that means if you extrapolate to 50 million loans, that would be about 500,000 borrowers who are in the process of foreclosure today.

Now, of those, three and four will not go to sale at the sheriff's steps or the courthouse steps. They may be solved by a restructuring of the loan; they may be solved in a deed-in-lieu transfer; there are about five or six loss mitigation processes that are undertaken. So there is a significant difference between the projections of foreclosures and the actual magnitude of foreclosures in process today. I can talk about that as a separate issue.

To address your question on the timing, it is certainly not several years ago that the loans that brought down the recent subprime companies were made. That was—and I would agree with Mr. Eakes that the 2006 book of subprime loans, which is the smallest of the recent cohorts of subprime loans, has performed at a worse delinquency and foreclosure pace than previous loans early in their life. And that was, by and large, the loans that were the difficulty for those firms that closed.

Mr. EAKES. Ten percent of the loans made in 2006 were already in foreclosure in the first—already in foreclosure, 10 percent.

Mr. DUNCAN. To the point of Ms. Womble where there was fraud committed, one of the big things that has been going on in the mortgage industry is the representation of loans in that foreclosure category which were fraudulent loans to begin with.

Mr. EAKES. One of the problems——

Chairman DODD. You don't disagree with Mr. Eakes on his number there, do you?

Mr. DUNCAN. I am sorry?

Chairman DODD. You do not disagree with Mr. Eakes on that number, do you?

Mr. DUNCAN. On which number?

Chairman DODD. On the 10 percent.

Mr. DUNCAN. I am sorry. Could you restate the——

Mr. EAKES. Ten percent of the 2006 book of business, according to Friedman, Billings, and Ramsey, is already in default.

Mr. DUNCAN. Is delinquent, yes. I believe those are publicly——

Mr. EAKES. Ninety days or more.

Mr. DUNCAN. On the securitized portion of those loans. Mind you that much of this data is only representing the securitized market——

Senator SHELBY. And are those securities still rated triple-A grade, or whatever?

Mr. EAKES. Moody's and others are starting to evaluate whether to downgrade.

Senator SHELBY. That is right.

Mr. EAKES. But here is the problem. What I think is very confusing, when you say, for instance, in the fourth quarter of 2006 that 1.8 percent of subprime loans went into foreclosure, what it is saying is they are looking at a snapshot in time. If you look at what are the loans that are currently right at this moment in time in foreclosure, and you say it is 1 percent or 1.8 percent, the problem is that every quarter you get new loans. There are new loans that go into foreclosure, that get sold off, the people have lost their homes. And if you just took that 1.8 percent and multiplied it times 12 quarters, which is the number—average life of 3 years for subprime loans, you would get back to this 20-percent foreclosure rate.

So there is a lot of gnashing of teeth about can it really be 20 percent, but if you track the borrowers, it will be substantially higher than 20 percent in this 2005–2006. And we are talking about millions of families who will not ever get compensated. They may not ever get a chance to own a home again.

Chairman DODD. Senator Crapo, one more question, and then Senator Martinez.

Senator CRAPO. Mr. Chairman, thank you. Just one more question. Just to help me understand the entire picture here, Mr. Duncan or Mr. Eakes, could you give us a comparison between the serious delinquency rates on subprime loans that we are talking about in comparison with, say, FHA loans or other prime loan markets? Do we a very significant differential there?

Mr. DUNCAN. In our data base, the delinquency rate for subprime loans is roughly 12 percent—that is almost the same as FHA—and prime loans are about 4.7 percent. In terms of foreclosure, the prime loans are at about one-half of 1 percent, and the subprime loans are at about 4.5 percent. The exact numbers I believe are in our testimony.

Mr. EAKES. But even that number tells you that the subprime ARMs are 9 times more likely to foreclose than an ARM loan in the prime sector, so that you get this huge impact—the amount of foreclosures in subprime as a whole compared to FHA is double. So it is similar customers, but with a product that does not have layering of all of these risk factors—the prepayment penalties, the failure to escrow for taxes and insurance, which is an amazing thing. By not having escrows, when the good lenders, the responsible lenders try to compete against a 2/28 mortgage, they start out with a loan payment per month that is 20 percent higher than what their competitor has. Guess how many loans they will get in a marketplace that is dominated by borrowers who are cash-strapped trying to look solely at the monthly payment? They will not get any loans.

So the general rule, of which that is an example, is that if you do not require escrow for high-risk loans, the good lenders, the good money loses out to the bad money.

Ms. CONSTANTINE-DAVIS. Could I just jump in here real briefly?

Chairman DODD. Ms. Davis, you wanted to comment on this.

Ms. CONSTANTINE-DAVIS. The word "fraud" has been used several times, and I guess being the lawyer geek on the panel here, I just want—we use "fraud," you know, in a colloquial way that says it is deception, it is a very broad range of things. But when you get down to trying to do a case and having to prove fraud, you have elements in the law that are very difficult. You have to have a higher standard of proof. You have to prove a material misrepresentation to the borrower. If you think about the inflated income cases, it is not a misrepresentation to the borrower. And you have to prove reliance, that the borrower relied on this. The borrower is not relying on it. They had no idea it happened. So in many ways, while in common parlance these are fraudulent transactions, they are not ones that you can necessarily prove as fraud cases in court.

Chairman DODD. Very good point. Very good point.

Senator Martinez, welcome.

Senator MARTINEZ. Mr. Chairman, thank you very much, and what an important hearing you have brought before us. I appreciate the panel and all the members being here.

I would not know how to begin because there are so many of these issues that I have dealt with and feel quite strongly about many of them. I believe that credit counseling is so very important, so important that consumers be better informed, and we need to continue to do what we can to encourage credit counseling, to encourage people to be informed and become better consumers themselves. But at the same time, there are market forces that absolutely, without a doubt, in my view, prey upon the innocent and unsuspecting.

One of the issues that I attempted to tackle was RESPA reform, and I know it did not always make me popular with some of the people in the room. But I must say I thought it was a good thing. And one of the issues that I was trying to tackle in that is what

I saw in Mrs. Womble's testimony where she said, "The closing costs had jumped from $8,000 to over $12,000. I did not want to sign the papers, but I felt I had to."

At that point it is too late to help the consumer. They have really got to have a good-faith estimate that is going to be in good faith within a very small digression from that, the same good-faith estimate that they are going to see at the closing statement. There ought to be room for there to be change, but it cannot be dramatic change. And there ought to be change in some areas but not in others.

I believe that the fiduciary duty of brokers is also very important. Yield spread premium—and I guess I am not just on a diatribe here. I need to ask a question or two. But yield spread premium, I mean, how do you have a broker who is, in fact, arguably in a fiduciary relationship, although I know they would say not, but who is, in fact, attempting to get the borrower into a higher interest rate so they get a larger commission? In other words, they are working at counter purposes to the borrower. And obviously the issue of loan flipping also creates a lot of problems. But I think yield spread premium, I think that the good-faith estimate, I think these are things that we can do through regulatory reform and whatever statutory changes are necessary to protect the vulnerable borrowers that are so unsuspecting in the marketplace.

And I would say while there are small percentages of people who get hurt, for Ms. King or Ms. Womble it is 100 percent. And so we have got to really look out for the most vulnerable.

I am not sure I have too many questions. I know the subject, and I appreciate the testimony of so many of you here today. I just believe that it is time that we try to do something to tackle some of these practices. And, you know, I believe there needs to be subprime lending. There needs to be a mortgage market available to those who do not have perfect credit so they can, too, get into homeownership. I believe homeownership is a way to open the future to so many financially by building equity, but with a fair loan. There are some of these lending practices that do not give people a chance, and then the most tragic of all is to already see someone that is in a home and then end up losing the home.

I am concerned about reverse mortgages for the elderly as well. That is another area where I think there could be an awful lot of abuse.

So, anyway, thank you all for coming, and I do not have a question. I am just with you.

Chairman DODD. Thank you very much, Senator Martinez.

Reverend JACKSON. Senator Dodd, could I add one more point?

Chairman DODD. Certainly.

Reverend JACKSON. You know, when we were fighting for voting rights, we were told that our problem was lack of literacy. You know, how many bubbles in a bar of soap and all kind of stuff, literacy, literacy. The problem was we did not have a law to protect us. So even the illiterate can be protected from bad law.

And so when I hear literacy, we should teach that through churches and our homes and the YMCA and all that. But these persons needed protection from bad law. We need law protection from you. We can work on financial literacy, and we do, in schools, in churches, and all of that. But somehow somebody violated these two women, and they are not going to face the weight of law. They need legal protection.

Chairman DODD. I do not disagree with that, and, in fact, Senator Martinez, could be a tremendous help to us here as someone who in his private life was in this business and in his public life. He was in the housing business in Florida, I know, from my conversations with him over the years, and, of course, at HUD, and did some great work back 7 years ago, as Hilary Shelton pointed out. So I think the point that Reverend Jackson makes is a very strong one.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman. I want to thank all the panelists, and I particularly want to thank Reverend Jackson for being here and being active in many quarters over many years that have made the country a better place.

I know you responded to the Chairman, Reverend Jackson, with respect to community impacts of these types of practices, but I wonder if you might have additional thoughts, having listened to the other panelists, about the impact on communities, not just individuals.

Reverend JACKSON. A study came out of Harvard not long ago. Usually when one house goes down, the houses next door are affected, and then the riot sets in. So in some sense, using the rotten apple situation, it is that when one house goes down, the very neighborhood starts dropping, unless there is something to offset that drop. And, again, we often think of just the poor or the black. I am very concerned about its impact upon black and brown people, the racial exploitation. But Appalachia—the same law must protect—a safety net must protect all of us from violation, the black, the brown. Yes, we are targeted. No question about that. The military bases, they know those are basically young people who got sent to war, who are over their head in debt. They had a job and now the military pays less than the job. So they go to the military. They are sitting outside the gates. Every time I go to a military base to speak to soldiers' spouses, you have got to go through a long line of predators to get into the gate.

And so it seems to me that we need to have a broader safety net, whether it is the military base people or whether it is when Ford takes away 55,000 jobs, what it does to Detroit and Dearborn and Youngstown or Akron, Ohio, what it does. The issue, it seems to me, there must be a safety net to protect people and a law to protect us from unscrupulous crooks. Both the law and the safety net.

Senator REED. Thank you.

Mr. EAKES. Senator Reed, there was a study in Chicago in 2004 that said that for every foreclosure within a one-eighth mile radius, it would reduce the value of every home by $2,800 to $3,000, for every foreclosure. So if you are in a neighborhood that is getting ten foreclosures, you could literally have the value of all the surrounding housing—because who wants to move into a neighborhood that has boarded-up houses. You could get to a point where the families that are there no longer have enough value in their home to even met the level of their debt and they are trapped. So there is very significant spillover effects from foreclosure.

Senator REED. Thank you very much.

Mr. DUNCAN. The mortgage lenders would agree with that, Senator. If you look for the alignment of interests between the borrower, the investor, and the mortgage lender, that clustering of foreclosures goes right to the heart of one of the products that the mortgage industry believes will be a valuable product for households where the bulk of their wealth is tied up in their house, and that will provide for them some assistance in retirement.

What I am speaking of is reverse mortgages. To the extent that you see the decline in the value of collateral, that is going to affect the economics of that household being able to access that.

Senator REED. Let me ask a question, D. Duncan. Is it your view that a lender should approve a person on a fixed income with a very modest savings for a mortgage policy like a subprime, 2/28 ARM, with the potential of very serious spikes in monthly payments? If that potential is real, it would seem that the person starts out already behind the eight ball?

Mr. DUNCAN. Well, it is our belief that the consumer should be informed about the performance of that mortgage should they choose that mortgage product or investigate that as one of their options. They should have full and clear information about the terms of the mortgage, how it functions in from economic environments, as opposed to other mortgage options. And if the consumer chooses that option, it should be with that full information. That is one of the reasons one of our principles is clear financial education and another one is clear information.

Senator REED. You know, I had the privilege of going off to a good law school and doing a lot of other things, and I was closing on my——

Chairman DODD. Harvard, I want to say. A good law school he is talking about here.

Senator REED. Couldn't get into UConn.

[Laughter.]

Chairman DODD. He was too short. He couldn't play basketball.

Senator REED. No athletic scholarship. And, you know, I was at the closing, and I was signing papers, like I think Ms. King and Ms. Womble, signing papers and signing papers. I am sure there was a disclosure. I could not really—that is our problem. We have to work on something that is vivid, and, you know, I am thinking maybe you would have to have a chart that shows the interest rate spiking in a year from now, and someone looks at it and says, "Oh, my God, next year I will be paying twice as much as I am paying now."

These calculations of, well, if this happens, it is now plus 25 basis points—frankly, you know, I did not know what a basis point was until I was about 30 years old and I was practicing law. Oh, that is a tenth of a percent. I think.

Mr. DUNCAN. We absolutely agree.

[Laughter.]

Mr. DUNCAN. First, I am sorry for your law school situation. I have the liability of being an economist.

We absolutely agree with you that consumers need some straightforward, clear tool to help them judge the relative risks of different loan products, and we have put together a task force of members under a title called "Project Clarity" to see if there is a way that the industry can offer up with consultation from the regulators and community groups something that paints the relative risk of different loan products, accounting for the potential changes.

Before I forget, if I may, we wanted to introduce into the record, given that there was some discussion about the differences in number, a critique that we have done of some of the CRL studies, if we can introduce that, without objection.

Senator REED. You have been a very good panel. It has been a long morning. I am concerned, Ms. King and Ms. Womble, who is helping you now? I mean, you are in a difficult situation. Is there anyone——

Chairman DODD. Reverend Jackson is going to help the one——

Senator REED. Well, good. Is there anyone—I mean, you are in a difficult position with your mortgage. How are you going to find your way out of it? Not just you in particular, but other people like yourselves, what should be done to help you? Better coordination with the lenders? Better community support in terms of helping, counseling? What do you think? You are the experts. Unfortunately, you have had a tough education, but you are the experts. Ms. Womble?

Ms. WOMBLE. At this point I am just sort of in limbo. I do not know what my next steps are. I know that one thing I would like to see is that consumers—that lenders do not just look at a number when it comes to the decision whether or not they want to make you a loan. Do not look at that number and judge you by that and say, well, you are subprime lending, you are not prime lending. Look at the whole situation, what happened.

You know, when I went from a 780 credit score 6 years ago to a 549 now, it is not that I just chose not to pay my bills.

Senator REED. Right.

Ms. WOMBLE. You know, it was circumstances. After 21 years of mortgage payments, I had never been late, never missed a mortgage payment. So it was just the circumstances that surrounded that. You know, I am a good credit risk. If you give me a mortgage payment I can afford, you are not going to lose money on me. Don't punish me for what happened in my credit situation when, you know, I am a good risk. You know, you give me that $900–a-month payment and I will not be here having to sit through these things and worry where my kids are going to get their next meal from, you know, if they have to go to the doctor. I have got, you know, coming up to go to college. How am I going to do that?

So that is what I would like to see, that they do not just look at that one number and say, well, you are below a 680 so we are going to send you down there.

Senator REED. Thank you.

Ms. King, any comments?

Ms. KING. Right now I am in a quandary——

Chairman DODD. A little closer, Ms. King, to that microphone. I am sorry.

Ms. KING. I am in a quandary because I am retired, and I never anticipated me being in a situation like this. What I would like to see is more clarity. If we are going to have brokers, be honest and aboveboard about it. If you can handle it, tell me now. I don't want like later I am sitting here testifying, not just for myself, for others that it concerns. And I really would like to see the law—because it seems like they are just getting away with murder. I really do feel that way.

Senator REED. Well, thank you both for your testimony, but also I think it underscores a point that several have made, and Reverend Jackson and others, that this is an issue that affects a wide range of Americans, people who have worked for years, have run their small businesses successfully, and then have a life-changing event. It does not affect their character or their diligence, their ability to work hard, but it makes it difficult for them to keep up, at least temporarily. And we have to be responsive to that in a decent way. And I hope we can work—I know the Chairman is very committed to this work to make things a little better.

Thank you.

Reverend JACKSON. Mr. Chairman, John Taylor from NCRSC wants to help Ms. Womble and Ms. King through some kind of consumer rescuethon. So when I said safety net, people who are seniors must know that safety net is not a predator, where they are being led to the slaughter. We just formed a village in Illinois called 40–50, where they decided to fight predators and took 10 zip codes, majority black and brown, a lot of predatory practices going on. You pay $300 for a counselor who helps talk you through your situation. Ms. King cannot be talked through. She needs some money. She needs to be offset from having—she has been violated.

And so our legislature voted for 40–50, but the counselors are working for the bank. The counselors are working for the subprimers and working for the bank. It is like a whole conspiracy, because we knew that in those zones where you have the most industrial jobs leaving and the highest taxes, and you just have block after block of foreclosures. And there needs to be some kind of money—I am back to if we can spend $9 billion a month on that situation in Iraq, we need some money. When people lose their jobs at Ford, when people lose—and seniors are trapped on fixed incomes, they need some bail-out, not just some counseling and some literacy.

Chairman DODD. Thank you very much, Reverend.

It has been a long morning for all of you, but tremendously valuable, and I just was looking over the numbers here again on this. You have Mrs. King who went from an $832-a-month mortgage to $1,500 a month, as I see it, roughly $1,500. That is an 80-percent increase. A woman on a fixed income. I think you said to me in your testimony you had an income of around $950 a month, you got another couple grand you got once a year, but that was going to terminate pretty quick as a pension. It came out of being a teacher over the years.

And in the case of Ms. Womble, you went from $927 to $2,000. That is over a 100-percent increase, and you had your insurance and other issues, taxes, that were now outside of that, no longer in escrow.

I think people need to remember this well. Ms. King was acting responsibly. She had a $3,000 debt she thought she owed, and she wanted to take care of her debts. You had a $10,000 judgment that you felt you had to meet an obligation. These are two citizens acting very responsibly -in fact, arguably, maybe too responsibly, to go through and refinance your home for $3,000 and $10,000. Someone should have given you some advice along the way that you did not need to do this, there was a way of dealing with those debts short of the avenue you chose.

But here are two very responsible citizens doing exactly what responsibility requires. Where is the responsibility, Mr. Dinham, I would say. Mr. Duncan, on the other side of the equation here, in the industry you are representing that would take advantage of two people who spent all their lives doing everything they should have been doing, hard-working, raising families, building private companies, a small business in this case, and then find themselves being victimized by a system here. That has just got to stop.

Now, you know, we can talk about the regulators, and we are going to bring them in here, because, frankly, I am annoyed that 2 months have gone by and no answer from these Federal agencies that can respond to this. So if you are listening to me, plan on being at this table in the next few weeks to respond to some questions.

Second, the industry had got to respond. Look, I am not crazy about writing laws here. I want to be careful that we do not do damage to the very industry that is critical for wealth creation. And I realize that by writing laws, you can unintentionally do some of this. So the industry has got to step up. That website, yes, change that, or step up to the plate and admit that you do have a fiduciary responsibility to these people. But you cannot have it both ways. You cannot advertise as being a mentor and advisor, and then turn around and watch these people get into the kind of holes they have gotten into. That is just outrageous, to put it mildly.

Also to my colleagues here, we need to look at the laws themselves, the statutory underpinnings of all of this.

So I am very grateful to all of you, and I am grateful to the industry, too. I appreciate, Mr. Duncan, you are very knowledgeable about this. I am very impressed how much you know. And, Mr. Dinham, your honest answer, I appreciate that. We do not always get honest answers, and I confronted you with the website. You said, "Yes, that is wrong." And I want you to know I appreciate that kind of answer. We do not always get those kinds of answers from people here. So I am grateful to you.

And, Hilary and Ms. Davis, your work, and Reverend Jackson, for your work here. But we are going to follow up on this. This is not just a one-time event here today to gather some information, but now to step up and see if we cannot stop this. Homeownership is really important. Subprime lending is a critical component for making people have an advantage of getting into the business of owning their own home. And I want to make sure it is going to work right and they can stay in that home for as long as they possibly can.

So we will be back at this, and I am very grateful to all of you for your testimony today.

The Committee stands adjourned. Thank you all.

[Whereupon, at 12:31 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

Invited Testimony of
Reverend Jesse L. Jackson, Sr.
President and Founder, Rainbow PUSH Coalition

Committee on Banking, Housing, and Urban Affairs
United States Senate

Wednesday, February 7, 2007
"Greenlining Redlined America"

Thank you Chairman Dodd for your vision in calling today's hearing as well as your insightful comments at the 10th Anniversary of the Rainbow PUSH Wall Street Project Economic Summit, established to democratize capital in the financial services industry and remove the walls on Wall Street for people of color and women. We look forward to joining with you in a working group on the issue of predatory lending, and other issues which will form the basis of a new national urban policy of America. On Thursday, January 25, this same committee held hearings on the practices of the credit card industry. What we will see here today is that several of the issues prevalent in the credit card industry apply to the issue of predatory lending.

Also, I would like to thank Senators Allard and Bunning who held hearings last year on Interest Only Mortgages. After all, in a true democracy, money is not red or blue or white; it should be green for all citizens.

As we gather for this hearing in the month of the year designated for the commemoration of Black History we do so through two lenses of history—triumph and tragedy. While NFL coaches who are Black are recent triumph in breaking down walls of exclusion in athletics the tragedy of Wall Street's targeting of people of color for high-rate home mortgages continues.

What is the American creed? The American creed promises equal opportunity, equal access, equal protection under the law, and fair share for all. Forty years after the passage of the Civil Rights Act of 1964, the Voting Rights Act of 1965, we much level the playing field for all citizens and identify incentives to financial institutions to invest—not exploit and oppress—hard-working Americans. Far beyond the idea of freedom is the reality of equity and parity. We must break the syndrome where the poor pay more; from automobile financing to insurance.

Today's terms of credit for African American (Black) and Latino (Brown) borrowers are un-American. The cost of money for Black and Brown people is not based on equal opportunity, equal access, or equal protection under the law. In the home mortgage industry—like other industries—people of color are economically exploited, resulting in a home-owning rate of fewer than 50%. For example:

- In 2005, 52% of mortgage loans to Blacks were high-rate
- In 2005, 40% of mortgage loans to Browns were high-rate
- By contrast, in the same year only 19% of mortgage loans to Whites were high-rate
- In Chicago alone, foreclosures for Black and Brown borrowers exceeds 598 million dollars annually
- In Boston, 70% of MIDDLE-CLASS (not the poor) home loans were high-rate
- Nevada has the highest foreclosure rate in the nation

IN SHORT, THE TERMS OF CREDIT IN MORTGAGE LENDING MUST MATCH AMERICA'S CREED !

Rather, many players in the home mortgage industry are given a "green light" to engage in predatory schemes to "red line" against the poor and people of color. Predatory lending practices such as sub-prime loans are the largest threat to wealth accumulation. Some such practices include:

- **Steering** – placing borrowers into higher-priced loans than those for which they qualify
- **Steering of prime** – placing Black and Brown borrower into high-cost sub-prime loans
- **Pre-Payment Penalties** – Fees incurred by borrowers for paying a loan off early

- **Yield-Spread Premium** – Broker kickbacks for steering borrowers into high-priced loans
- **No Thought to Repayment Ability** – Failure to escrow for property and taxes low-documentation loans

Today, I pray the Senate Banking Committee does not…

- Blame the victims; or
- Suggest a mere increase in disclosure forms

I respectfully suggest:

1. **The Industry is not functioning properly**

   Lenders and brokers have financial incentives to place borrowers in more expensive loans. It puts responsible lenders at a competitive disadvantage with the irresponsible lenders allowing unscrupulous predatory lenders to control the market. Currently, brokers get paid more by putting borrowers in more expensive loans for which they qualify. And, lenders have incentives to place borrowers in loans that are unsustainable for more than a year or two. THIS MUST CHANGE

2. **GSE's must be held accountable**

   Rainbow PUSH has worked with the GSE, Fannie Mae to develop predatory lending practice guidelines, which were adopted. Currently, evidence reveals that Fannie Mae is purchasing securities that include the very loans that are stripping working-class people of their precious home equity. The federal government subsidizes Fannie Mae to increase homeownership opportunities for working people. In purchasing such securities—and profiting of predatory loans—Fannie Mae is violating its public mission and the "ABILITY TO REPAY STANDARD". I also have learned that Fannie Mae received "HUD Goals Credit" while investing in high-rate loans that produce massive foreclosures. In short, Fannie Mae and other GSE's are doing through the back door what the law prohibits through the front door. THIS MUST CHANGE.

3. <u>Borrowers should not shoulder the blame</u>

I am very discouraged by the industry response to necessary change. What I hear from the industry is "Educate the borrower. Increase disclosure". Rainbow PUSH, through our 1000 Churches Program teaches financial literacy to member churches across the nation. And there are other organizations doing the same to provide borrowers with information to make good financial choices. To think that more forms, bigger font and more "1-800" numbers is a remedy is to view the issue through a key hole and not the entire door. "Duty to read" standards for the public must be matched by "duty to behave" for predatory lenders.

Federal law requires banking regulators to protect citizens, regardless of race. What we fight for is one set of rules, evenly applied to all Americans—whether Native American, African American, Latino American, Asian American, or European American. Red, Black, Brown, Yellow or White, we are all precious in God's sight.

Thank you, and keep hope alive!

Ms. Delores King
11114 S. Normal Av.
Chicago, Illinois 60628

TESTIMONY BEFORE SENATE BANKING COMMITTEE
February, 2007

Thank you for the opportunity to testify here today about my mortgage. My name is Delores King, and I live on the South Side of Chicago in a home I have owned for 36 years - it will be 36 years this August. I am a retired office administrator after 23 years on the job in the offices of the Chicago School of Optometry.

Over the years, I have refinanced several mortgages on my property, in order to make repairs and various improvements. In 2004, my mortgage balance was $140,000, and I was paying $798 per month on my mortgage.

In 2004, unfortunately, I was the victim of an identity theft phony check scam that cost me about $3,000. I decided to refinance my mortgage in order to borrow the money I owed as a result of the scam. What

Around February, 2005, I received a telemarketing call from Chad, a mortgage broker with a company called Advantage Mortgage Consulting. Chad told me that he could get a loan for me approved fast. He said that he would get me a good loan for my situation. So, I applied for a loan with Chad. I told Chad that my monthly income was about $950 per month from Social Security. My only other income is a one-time-a-year retirement payment from a Teachers pension from the optometry school, in the amount of $2,657 - once a year. This pension will actually stop in a few more years. Currently, I have a part–time job as a Foster Grandparent at a grade school where I make $2.65 per hour.

Chad took copies of my Social Security and pension benefits statements, and a few weeks later he told me I was approved. He brought the loan papers to my house and asked me to sign - many, many pages of documents. He rushed me through the signing and did not really explain anything. He certainly did not say this was an "exotic" loan or unusual in any way. He didn't even give me copies of the papers I signed – I had to call and get them from the title company much later.

When I agreed to the loan, Chad said it was an adjustable rate, but the starting interest rate was only 1.45%. He said the regular rate would be around 6%, and the payments would be around $800 per month. I believed that the starting rate would last at least six months or a year before adjusting. I had heard about mortgages that adjust once a year. I knew that the payment could go up little by little, but I had no idea it would explode the way it has in just two years. I also did not know that $800 per month was less than all of the interest due, and that my balance would go up and up with unpaid interest. So now I have a mortgage that's thousands of dollars more than I started with, and my payments have nearly doubled in two years. I have refinanced before, but I've never seen anything like this.

The payment started out as $832 a month, including taxes and insurance. The monthly payment as of now is $1,488 per month. This is more than my entire monthly income! I have been scraping by with the help of family and friends to get my mortgage paid every month, but I am now at the point where it is just impossible to continue. Last month, I could only send in $1,200. I will end up out on the street if something doesn't change soon.

I never heard of a “no doc” loan or an “option” loan before all this happened. I never knew you could get a mortgage and pay “interest only” or even less than all the interest owed each month. I surely did not know that a Bank would make a loan to someone without checking to see if the person could afford the loan. This loan is just not right for someone like me. If the bank had looked at my information, my income, they knew I could never afford this loan. The bank knew, but I did not know, that the monthly payment could go higher than my entire monthly income, my fixed income. It should be against the law for a bank to make a loan knowing that it will be impossible for the person to pay it back and they will lose their home.

Testimony of
Ms. Amy Womble, Consumer from Pittsboro, North Carolina

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

My name is Amy Womble and I live in Pittsboro, North Carolina, with my two sons, Josh, who is 18, and Jeremy, 16. My husband died in October 2000. Before he died, we had excellent credit. We built a house on five acres and had a mortgage we could afford. My husband and I worked together in a small construction company we owned, a land clearing and grading business that was organized as a Subchapter S Corporation.

My husband's death was totally unexpected; he was only 37 years old. After he died, I struggled as the single parent for my two boys, 10 and 12 at the time. Though I had no more income from our business, I was personally liable for a lot of business debt. One final problem came last year, when a bank filed a $10,000 judgment against me for an old business debt. I was very worried about how I would be able to pay this off.

One evening while I was on my computer, a pop-up advertisement for debt consolidation at low interest rates caught my eye. I contacted the company, which turned out to be a California mortgage broker. The broker arranged to refinance my home loan with a company called Saxon Mortgage. The broker sent me a Good Faith Estimate showing that my new monthly payment would be $927, my closing costs would be $8250, and I would receive almost $26,000 at closing.

All this sounded good to me, but the closing kept getting delayed. The loan officer told me not to make any payments on my current mortgage because the refinance would happen any day. By the time the closing actually took place, I had used my mortgage money to pay medical bills, so I was feeling a great deal of pressure to close on the new loan.

The first time I saw the new Good Faith Estimate was at the closing table last June. The monthly mortgage payment had jumped from $927 with escrows for taxes and insurance to over $2100 without escrows. The closing costs had jumped from $8000 to over $12,000. I did not want to sign the papers but I felt like I had to. The loan officer told me I would only have to make one payment. He said he had a credit specialist who would remove all the negative things on my credit report. With this higher credit score, he said he would turn right around and refinance me again and that my mortgage payment would be the $927 that he had originally promised.

Before we closed, the broker was very nice and seemed genuinely concerned about helping me. After the closing he just disappeared. Over the next 5 months, he never once returned my phone calls, and as you can guess, I did not get that credit repair help or the lower monthly payment he promised.

Later, I also found out that he had misrepresented the information that I had given him on our household income. I had provided copies of our social security statements, showing that I had a total monthly income of $2751 in widows' and survivors' benefits. But the application he prepared shows our household social security income at $4034, and that was "grossed up" by 125% to $5042. So the income he stated for us was almost twice what I actually receive. I was truthful in everything I told the loan officer, but on the day of the closing I had to sign a lot of documents without time to read them all. I didn't know that my income had been misrepresented on the application that he prepared.

I now know that the worst of it all involves the terms of the loan itself. My loan is an adjustable rate mortgage, with a balloon payment, which means that I will have a very large debt left to pay even after paying on the loan for 30 years. My loan currently has an APR of 12.5% (interest rate of 10.4%) and the interest rate can go as high as 16.4%. The lender has estimated that I will make 24 payments of $2147, then 335 payments of $2528, and after 30 years, I will owe a final balloon payment of $176,070. I had no idea this loan even had a balloon payment until last week.

The lender has calculated that for the $231,650 amount financed that I will pay $1,074,412 over the life of the loan.

My main goal in getting this loan was to lower my monthly payment, pay off my $10,000 business debt and clear my judgment, and get some extra money to tide me over. What I got is a loan with $12,000 closing costs.

I thought I was getting a fixed monthly payment of $927 including taxes and insurance. What I got is a starting payment of $2147, which will only go up from there, and that doesn't even include taxes and insurance.

I thought I had a loan I would pay off in 30 years. What I got is a $176,000 balloon instead.

I thought I was lowering my monthly payment. Instead, I refinanced from my original loan with a fixed rate and a lower monthly payment into a new loan with an adjustable rate, a balloon payment, and a higher monthly payment, even at the starter rate. This new loan takes up 78% of my monthly income. Actually, it takes up even more than that because the payment does not include taxes and insurance. When you add those in, this loan takes up 86% of my monthly income, leaving me with $388 a month for my family to live on.

Since I took this loan, I have had to access my equity line, pulling even more equity out of my home to meet this monthly payment. There are times when I can't afford to buy food, so my teenage boys have cereal for dinner. I am lucky it is winter, because otherwise the power company would have already cut us off.

I can afford my home, but not with this home loan. There is no way I can continue to make the payments required by the terms of this loan. Now, I am worried about losing my home, my sons' home, the home my husband and I worked so hard for.

Thank you very much for listening to my story today. It is hard for me to talk about this loan. I thought I was making a smart decision for my family, but it has turned out to be a nightmare.

I hope that my speaking out will help others understand how predatory lending really works and why we need strong laws to prevent it. Thank you for inviting me to speak today. And, again, thank you for listening to my story.

National Association of Mortgage Brokers

Prepared Testimony of

Harry Dinham, CMC, NAMB President

National Association of Mortgage Brokers

on

"Preserving the American Dream:

Predatory Lending Practices and Home Foreclosures"

Before the

Committee on Banking, Housing and Urban Affairs

United States Senate

Wednesday, February 7, 2007

Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I am Harry Dinham, CMC, President of the National Association of Mortgage Brokers ("NAMB"). Thank you for inviting NAMB to testify today on preserving the American dream of homeownership. We appreciate the opportunity to address the need to prevent predatory lending practices and assist those Americans facing foreclosure while maintaining a competitive and strong housing market.

We commend this Committee for holding this important hearing to identify, examine and address the underlying reasons for the most recent rise in mortgage delinquencies and home foreclosures. We appreciate the salient concerns raised by this topic.

It is a tragedy for any consumer to lose their home to foreclosure. At the same time, America enjoys an all-time record rate of homeownership. The challenge before us is to find a solution to the tragedy of foreclosure while at the same time ensuring that consumers continue to have access to the credit they need to finance their homes.

I. Record Homeownership

In 2002, the President called upon the real estate and mortgage-finance industries to help accomplish "America's Homeownership Challenge" ("Challenge"). This Challenge called on the industry to take "concrete steps to tear down the barriers to homeownership that face minority families."[1] The President set a goal of increasing the number of minority homeowners by 5.5 million families by 2010.

Shortly after the President's Challenge was released, the Department of Housing and Urban Development ("HUD") released a report that identified the most significant barriers to minority homeownership (the "Report").[2] The five major obstacles listed were:

1. lack of capital for the down payment and closing costs;
2. lack of access to credit and poor credit history;
3. lack of understanding and information about the home buying process, especially for families for whom English is a second language;
4. regulatory burdens imposed on the production of housing; and
5. continued housing discrimination.

The Report stated that, combined, these factors "produced a gap in which non-Hispanic whites enjoyed a 68 percent homeownership rate, compared to only 48 percent for African-Americans and 47.6 percent for Hispanics." Echoing the President's Challenge, HUD also called upon the real estate and mortgage lending industries to "increase their levels of product innovation and marketing to minority families in order to sustain" growth rates achieved in the 1990s.

The industry responded. To achieve the goals set by the Administration and reaffirmed by HUD, mortgage originators, realtors, lenders, underwriters, and the securitizers and investors of Wall Street worked together to develop and deliver innovative loan financing options. These options allowed more Americans to achieve the dream of homeownership and brought about record rates of homeownership that have reached nearly 70 percent. New products are credited with addressing exactly the concerns identified in HUD's Report – providing financial options to families with little or no credit access, minimal, if any, down payment, lower monthly payments, and less "cash-out-of-pocket" at closing.

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[1] "A Home of Your Own: Expanding Opportunities For All Americans." George W. Bush (June 2002). http://www.whitehouse.gov/infocus/homeownership/homeownership-policy-book-whole.pdf

[2] "Barriers to Minority Homeownership." U.S. Department of Housing and Urban Development (June 2002). http://www.hud.gov/news/releasedocs/barriers.cfm.

Achieving a homeownership rate of almost 70% and enabling more minority families to enjoy the multitude of benefits offered by homeownership – from community investment to wealth-building ability – is an impressive accomplishment for which the entire mortgage industry, along with this government, deserves credit. The zeal to achieve the benchmarks and objectives laid out by the current Administration has resulted in circumstances that now present industry and the government with a set of new concerns and challenges.

II. Today's Reality: Rising Delinquencies and Foreclosures

Today consumers, industry, and government are challenged by the rising number of mortgage delinquencies. Consumers are faced with the prospect of losing their homes. No one questions the tragedy of this fact. Even one family losing their home to foreclosure is one too many, regardless of the cause. For this reason, NAMB is committed to working with this Committee and others to ensure that homeowners have continued access to affordable credit and are able to preserve their dream of homeownership.

But the unanswered question is: what is causing the rise in mortgage delinquencies and home foreclosures? No one knows for sure, but we believe there may be a number of factors:

- New homeowners unprepared for the costs and responsibilities of homeownership;
- Bankruptcy Reform;
- Speculative bubble in real estate values;
- Refinancing to cure delinquencies;
- Minimal wage gains;
- Illness and other life events;
- Credit card debt;
- Decreased savings rate;
- Fluctuating home values;
- Mortgage Fraud;
- Consumer Fraud;[3]
- Appraiser Fraud;
- Title Insurance Fraud;
- Predatory Practices;
- Risk layering;
- Consumers desire to live above and beyond their means;
- Cash-out refinancing to maintain unsustainable standard of living;
- Consumer financial literacy;
- Owner v. non-owner occupied;
- Buyers of property with an intent to resell quickly;
- Criminal Enterprises;
- Bad Acts and Bad Actors;
- Investors and Speculators;

[3] *See* Merle Sharick, Erin E. Omba, Nick Larson, D. James Croft of Mortgage Asset Research Institute, Inc. *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association* (pg. 12) (April 2006) http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf.

- Shrinking middle class;
- Exporting of jobs;
- New replacement jobs at low wages;
- The role of the secondary market;
- Regional job loss;

And the list goes on. The chances are unlikely that there is one cause of foreclosures.

III. No Rush to Judgment

Before we rush to judgment and conclude that a particular segment of the mortgage market or practice is largely responsible for the increase in home foreclosures, it is imperative to at least examine and verify the true causal factors for the increase in mortgage delinquencies and home foreclosures. We should not jeopardize the vast majority of consumers who have succeeded in using many innovative loan options to attain and maintain their homes. Do not forget those consumers who could benefit in the future from these innovative loan options.

Today, we can only speculate as to the reasons for the increase in mortgage delinquencies and home foreclosures. As a result, we can only make assumptions and take what is tantamount to a trial-and-error approach to possible resolutions. We have no assurances that current proposals are either appropriate or will yield desired results. NAMB does not believe that consumers should continue to suffer as we take a 'trial and error' approach—it is unfair and can result in unintended consequences.[4]

NAMB believes the problem of rising foreclosures is complex and will not be corrected by simply removing products from the market. As a study by the Office of the Comptroller of the Currency in 2006 states, "the relationship between predatory lending practices and foreclosure rates is more complicated than the arguments for restricting their (nontraditional loan products) use suggest. Policies that encourage subprime lenders to review and tighten loan underwriting and pricing procedures to ensure borrowers' abilities to repay their loans are fully reflected in lending decisions and terms may be more effective than prohibitions on specific lending practices."[5]

Instead, NAMB believes government and industry should take a step back and evaluate all the factors that could play a role in determining whether a family is forced to foreclose on their home.

IV. The Need for an Independent Study

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[4] *See* Mary Umberger, *Home buyer Counseling Challenged*, Chicago Tribune, Nov. 2, 2006. *See*. *https://www.hb4050info.com/Public_Web/Home.aspx* for more information on the Cook County Illinois Predatory Lending Database, mandated by Article 3 of the Residential Real Property Disclosure Act1, ("H.B. 4050") that led to falling neighborhood values, discrimination lawsuits, and lenders pulling out of the area. The program was suspended on January 27, 2006. *See https://www.hb4050info.com/pdfs/4050Scan001.pdf*

[5] Morgan J. Rose "Foreclosures of Subprime Mortgages in Chicago: Analyzing the Role of Predatory Lending Practices." (August 2006).

NAMB firmly believes that an independent study to identify and examine the causes of foreclosures is necessary before we can create well-designed and effective solutions. Although numerous foreclosure studies exist, they are not independent and tend to focus solely on *a* single causal factor. To understand the true causal effects of foreclosures, NAMB urges Congress or the Administration to fund an independent study that is sufficiently broad to encompass all of the above-mentioned factors and is performed over an adequate period of time to take into account seasonal and cyclical changes in the market.

A long-term, independent study will aid the industry and government in determining the appropriate steps for long-term solutions to the foreclosure problem while ensuring that consumer choice, product innovation and the ability to maintain record rates of homeownership are not negatively impacted. In addition, NAMB believes that to pursue a comprehensive approach to the issues raised by the increase in foreclosure rates, we must include not only originators in the discussion, but also those who fund, service and collect on mortgage loans. Origination is but one step in the process of how a consumer secures financing to achieve and maintain homeownership.

However, as we all acknowledge and confront these problems and in our zeal to protect consumers from or help them weather the causes of foreclosures, whatever they may be, NAMB urges consumer advocacy groups, industry and the government not to forget the original goal to increase homeownership and the success that has been achieved by creating new products. Today, more Americans own their home than ever before and while we must work to ensure Americans are able to stay in their homes, we must also be cognizant of the unintended consequences the policies we develop can have on families who have not yet achieved homeownership. As we move forward, NAMB urges government to use caution so as not to upset the balance created by the market that provides homeownership opportunities to so many Americans.

V. Policy Recommendations

Although we believe that this independent study must be performed, we appreciate that it is a long-term project that will not provide immediate relief to those consumers suffering from or facing the prospect of home foreclosure. We must also develop short-term solutions.

As discussed previously, the industry responded to this Administration's Challenge to increase homeownership. In the past five years alone we have witnessed a proliferation of market players and the development of numerous innovative loan products. Together, these developments have resulted in a healthy and competitive market that offers increased access to affordable credit.

But during this same time period, there were missed opportunities to address the growing need for a simplified mortgage process; prevent payment shock; and ensure that all loan originators were able to communicate the risks and benefits of increasingly complex loan products.

Now is the time to act. NAMB takes this opportunity to emphasize once more the need for Real Estate Settlement Procedures Act of 1974 ("RESPA") Reform; uniform, minimum education standards for all loan originators; and committed funding towards enforcement and consumer financial literacy efforts. In addition, NAMB proposes the creation and use of a loan-specific disclosure to communicate key loan features upfront and deter the prospect of payment shock.

Before we address each of these policy proposals, we want to emphasize that regardless of what measures we pursue, we should (1) ensure that the integrity of the consumer decision-making process remains intact, and (2) that we do not risk 'turning back the clock' to a pre-Fair Housing Act era where certain population segments were unfairly denied access to loan financing options.

A. Protecting the Consumer's Right to Remain the Decision-Maker

The consumer is the ultimate decision maker on the product, the price and the services purchased in conjunction with obtaining their financing. No merchant, no government and no company should superimpose their own moral judgments on what is a basic American privilege of homeownership.

Some have proposed that a fiduciary duty standard should be implemented and mortgage originators and their loan officers should act in the "best interests" of the consumer. NAMB remains opposed to any proposed law, regulation or other measure that attempts to impose a fiduciary duty, in any fashion, upon a mortgage broker or any other originator.[6]

Simply put, a mortgage broker should not, and cannot, owe a fiduciary duty to a borrower. The consumer is the decision maker, *not the mortgage broker*. Mortgage brokers do not represent every loan product available in the marketplace, nor do we have the "best" loan available. Rather, the mortgage broker enters into contracts with various lenders and is then able to offer such lenders' loan products directly to the consumer. This is a critical point because there is no "best" result. What is "best" depends upon three inter-related concepts: product availability, price, and service. Focusing solely on a price of a product may not yield the "best" result for a consumer. Only the consumer can determine the "best" combination of factors that fit their needs.

Some have suggested that mortgage originators (not exclusively mortgage brokers) be subject to a suitability standard when dealing with consumers. This concept has not been thoroughly defined in the mortgage context. An ill-defined and vaguely worded suitability standard will do nothing more than inject greater subjectivity and vagueness into a process that today should be incorporating mostly, if not only, objective factors. Moreover, such a standard will create uncertainty and confusion in the marketplace, spurring litigation, which in turn will increase the cost of credit.

Some have suggested that mortgage brokers are not regulated. We disagree and we have submitted for the record a memorandum that highlights the federal and state laws that govern our industry.[7] It is difficult to harmonize the assertion that the mortgage originator industry suffers from inadequate oversight and enforcement with a proposal that will require these very same originators to make highly discretionary and subjective judgments.

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[6] *See* Attached Appendix A, *The Relationship of the Mortgage Broker to Its Consumer.*
[7] *See* Attached Appendix B, *The Regulation & Oversight of the Mortgage Broker Industry.*

For these reasons, no law or regulation should ever require any mortgage originator to supplant the consumer's ability to decide for him or herself what is or is not an appropriate loan product. As the decision-maker, the role of the consumer is to acquire the financial acumen necessary and take advantage of the competitive market place, shop, compare, ask questions and expect answers.

B. Out-Dated Disclosures

NAMB supports clear, consistent, and uniform communication with the consumer from the shopping stage through consummation and afterwards throughout the life of the loan (*i.e.,* monthly statements). Disclosures – when designed and used appropriately in conjunction with originator and consumer financial literacy efforts – alert potential borrowers to the risks and benefits presented by any particular loan product and support meaningful comparison shopping. Disclosures aid the consumer in exercising their right to make an informed choice.

NAMB reiterates the need to revise existing mortgage disclosures. We encourage HUD and the Federal Reserve Board (the "Board") to review and update key disclosures given to consumers during the home buying process, such as the GFE and the Truth In Lending ("TIL") statement. These disclosures are critical to the home buying process and should be modernized to reflect the growing popularity of nontraditional mortgage products in the mortgage market.

1. GFE Reform

In 2005, NAMB proposed a one-page GFE[8] in response to a series of roundtables conducted jointly by the U.S. Department of Housing and Urban Development and the Small Business Administration throughout the summer of 2005. This one-page GFE mirrors the HUD-1 consumers receive at settlement and communicates not only the loan features and costs, but fully discloses the role of the loan originator in the mortgage transaction. Most important, the revised GFE would provide the information most valued by the consumer—meaningful closing costs and monthly payment.

The one-page GFE is a viable solution to the problem of abusive lending because it applies equally to all segments of the mortgage industry; is effective in preventing abusive lending tactics, such as bait-and-switch schemes; is informative because it clearly and objectively informs the borrower of the role of the loan originator in the transaction; and is enforceable, because it grants the consumer a private right of action.

Specifically, the NAMB proposed GFE possesses four distinct attributes:

First, it is even-handed. The NAMB proposed GFE would be equally applicable to all originators conducting business in the mortgage marketplace. Of import, the proposed NAMB GFE treats the disclosure of rate, fees, costs and points uniformly regardless of distribution channel, giving meaning to the ability to "comparison shop." As a result, distribution channel bias is eliminated and all consumers are afforded the same level of protection against abusive lending tactics.

[8] *See* Attached Appendix B, *NAMB Proposed GFE.*

Second, it is informative. The NAMB proposed GFE clearly discloses the role of the originator in the mortgage transaction. The borrower is notified that the loan originator does not distribute all of the loans available in the marketplace and therefore, can not guarantee the lowest rate. This aspect of the proposed GFE is significant. For example, as discussed previously, a loan product offering the lowest interest rate may not necessarily be the "best" loan product for the borrower. It is far more effective to disclose the role of the broker, the loan features and costs, and empower the consumer to comparison shop and choose a product that suits his or her needs. Also, requiring that every mortgage originator disclose his or her role and relationship with the borrower will eliminate any confusion on the part of the borrower—this approach actually ensures that a borrower is not operating under a faulty impression that an originator, such as a bank-affiliated mortgage lender, owes him or her a fiduciary duty.

Third, it is effective. The NAMB proposed GFE is effective in combating abusive lending tactics because it provides simplicity, clarity and transparency of the loan costs and features. It is one-page in length; mirrors the HUD-1 settlement statement; requires mandatory re-disclosure if settlement costs increase by more than 10% of the original estimate, or if the proposed interest rate increases.

Fourth, it is enforceable. Consumers are given a private right of action to enforce the GFE tolerance limits of 10% if no timely re-disclosure is given to the consumer.

We believe the NAMB proposed GFE form will build consensus among stakeholder groups while achieving HUD's stated goals of simplicity, clarity, transparency, and greater cost certainty for consumers. However, it is now 2007 and HUD has yet to release a revised version of the GFE. NAMB urges HUD to move forward with in working with the industry to develop and roll-out a GFE that incorporates the key elements outlined above and is more beneficial to consumers.

2. Loan Specific Payment Shock Disclosure

Current disclosures have failed to keep pace with market innovations, especially in the area of variable rate loans. Today, consumers are not given the tools needed to shop effectively for a mortgage in a market offering increasingly creative and complex options. Disclosures are laden with legalese, inconsistent, not required uniformly across all distribution channels, and fail to provide the information that consumers need most when making a decision. Most notably, there is no current loan specific disclosure that communicates to the borrower the variability of their monthly payment (*i.e.*, your monthly payment can go up to X) or interest rate (*i.e.*, your current interest rate is valid only for X months).[9] As a result, consumers are left confused, unable to comparison shop loan products and subject to payment shock. There is a critical need for a uniform disclosure required across all distribution channels that will clearly and concisely impart

[9] TILA does not adequately reflect the changing payment scheme and interest rate of many loan product types available on the market today. The recent CHARM booklet, as well as the new Interest Only & Pay-Option ARM booklet, provide excellent background information, but lack the specificity about a loan product's features that the consumer needs to know when deciding which loan product meets their needs.

loan specific information to the consumer and prevent unwanted surprises about payment shock and interest rate variations.

NAMB proposes a loan specific payment disclosure notice that will: (1) educate the consumer about the specific loan product being considered and/or chosen, and (2) enable consumers to exercise an informed and independent choice about a particular loan product. A mortgage originator knowledgeable about the various market products would be able to also assist the consumer in understanding the information provided on the loan specific disclosure – the risks, the benefits and the choices available.

To address the issues of payment and interest rate shock, we recommend:

1. Requiring all loan originators to provide consumers, regardless of loan-product type, with a loan-specific payment disclosure;
2. This disclosure will show the consumer payment variations, (*e.g.*, a minimum and maximum payment for every loan product), interest rate variations, and disclose information about pertinent features such as prepayment penalty and negative amortization, if applicable;
3. This disclosure can be implemented through regulation to speed its implementation. Specifically, the initial loan-specific disclosure provided early in the shopping stage can be required through RESPA (*e.g.*, can accompany the estimated GFE), and the final loan-specific disclosure can be required at closing through Truth In Lending Act ("TILA"); and
4. Consumer testing by an independent third-party or governmental agency prior to implementing and requiring that all originators provide this disclosure.

A uniform and straight-forward disclosure, such as the one proposed here, will aid in the comparison shopping process for consumers and will provide a more simplistic explanation of the "worst-case-scenario."

C. Standard Education Requirements for All Mortgage Originators

NAMB believes that part of the solution to successfully combat abusive lending tactics and reduce the number of foreclosures in America is to require education of all mortgage originators – not just mortgage brokers. All consumers Education of each and every mortgage originator helps to ensure that consumers are provided with sufficient information to make an informed decision about available loan financing options in the market.

To ensure all mortgage originators are well educated and knowledgeable about all loan products, NAMB has long advocated for uniform licensure, education (including ethics training) and criminal background checks for each and every individual that handles a 1003 application,[10] *i.e.* every mortgage originator.[11] NAMB agrees that all "[l]ending personnel should be trained so

[10] A Form 1003 is a Uniform Residential Loan Application.

[11] The basic requirements of education, continuing education, ethics training, written exams, and criminal background checks can be found in NAMB's ongoing work and commitment on the Model State Statute Initiative (MSSI) that NAMB began in 2002, which is attached hereto as Appendix C.

that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner."[12]

NAMB is committed to ensuring that all originators are knowledgeable about the range of loan products available in the marketplace and understand the features, risks and benefits of the loan types that they offer. For this reason, we support federal efforts to implement a national minimum standard for all states to meet or exceed in lieu of a federal licensing mandate.

D. Financial Literacy and the Borrower

NAMB believes consumers should possess the necessary financial knowledge to carefully evaluate the risks and rewards of traditional and nontraditional products. Financial literacy is the tool that consumers need to make an informed decision as to whether a particular product—traditional or nontraditional—meets their needs. Financial literacy is also a valuable tool that will help consumers avoid foreclosure. If a consumer understands the risks and rewards of the product they have chosen, they will have a better understanding of how to stay in their home and avoid foreclosure.

Regardless of how knowledgeable a mortgage originator is or becomes, an educated consumer is always in a better position to make an informed decision when selecting a loan product that can match his or her financial needs. Borrowers must possess the financial literacy tools to properly evaluate the risks and benefits of nontraditional mortgage products that have been highlighted and communicated by the educated mortgage originator. For this reason, NAMB urges Congress to allocate funds for financial literacy programs at the middle and high school level so that consumers are educated about the financial decisions they make and retain their decision-making ability.

NAMB has always been a staunch supporter and advocate for consumer financial literacy. Our firm belief that an educated borrower is significantly less likely to fall victim to any abusive lending practice and to avoid foreclosure is demonstrated by our active involvement in various consumer education efforts. For example, NAMB initiated a pilot consumer credit education program using Freddie Mac's CreditSmart® and CreditSmart® Español financial literacy curricula. The pilot is currently being managed by NAMB state affiliates in California, Florida and Texas. NAMB partnered with United Guaranty in 2003 to create a consumer information presentation – "Are You Prepared to Head Down the Road to Homeownership?®" – to help educate minorities, immigrants and low-to-moderate income households on the home-buying process. The presentation covers common home mortgage terminology, important steps in the home-buying process, fair housing laws, credit reports and more.

We recommend Congress to put forth measures and explore those avenues that outreach to borrowers and provide meaningful education to them in a timely fashion rather than just at the time of application or at the closing table. Possessing a fundamental understanding of the mortgage lending marketplace and the loan product types available will empower borrowers to comparison shop, ask meaningful questions and make financial decisions that advance their personal life objectives. Again, NAMB strongly believes that because financial education is the

[12] *See* Proposed Interagency Guidance on Nontraditional Mortgage Products (December 2005) p.35.

key to choosing the right loan product and protecting oneself against fraud, the consumer education process should begin at a young age. To this end, NAMB supports any effort that calls for federal funding to support consumer financial literacy efforts and outreach programs during the school years.

Again, thank you for the opportunity to appear before this Committee today to discuss this timely issue. I am happy to answer any questions that you may have.

Appendix A

NAMB
National Association of Mortgage Brokers

The Relationship of the Mortgage Broker to its Customer

The majority of mortgage brokers are small, independent businesses operating retail offices open to the public for the purpose of obtaining mortgage financing. Like any retail source, the mortgage broker has wholesale distribution channels which supply them with inventory, in this case, a variety of mortgage products. The mortgage broker provides rate and price flexibility and among other things, offers numerous loan products, collects information from the borrower, communicates such with the lenders and facilitates closings. The public, in turn is able to choose the product offered by that particular mortgage brokerage firm. If the shopper does not find the product or price they want, they go to another mortgage source.

It has been suggested that we should be the fiduciary agent for the borrowing consumer .The mortgage broker is **not** the exclusive agent for the lender **or** the borrower. The mortgage broker is an independent entity that typically has contractual loan origination arrangements with multiple wholesale lenders. As an independent entity, mortgage brokers rely on referral business, which is obtained by offering a combination of good customer service, a variety of mortgage products and competitive interest rates. A broker that does not offer all of the afore-mentioned, will most often not get the business, since customers have the ability to shop for the rate, product and service that they prefer. Since not all mortgage brokers offer the same loan products or are approved with all lending sources, it would be impossible to assure the "best" mortgage options to every customer, thus making fiduciary responsibility unattainable.

A member of the National Association of Mortgage Brokers adheres to a strict code of ethics and best lending practices which can be found at www.namb.org. Mortgage brokers do the majority of all the mortgage loans in this Country and the public has declared us their mortgage originator of choice. For the past several years the borrowing public has opted to use the mortgage broker as their lending source, primarily because of competitive pricing, varied mortgage products, professional service and convenient location and hours.

Appendix A

National Association of Mortgage Brokers

The Relationship of the Mortgage Broker to its Customer

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Appendix B

National Association of Mortgage Brokers

THE REGULATION & OVERSIGHT OF THE MORTGAGE BROKER INDUSTRY

Background Information

There are a variety of distribution channels in the mortgage industry today, and each of these distribution channels is heavily regulated at both the state and federal level. Mortgage brokers, like bankers and other lenders, comply with every federal law and regulation affecting the mortgage loan origination industry. Additionally, mortgage brokers comply with a host of state laws and regulations affecting their businesses, from which bankers and lenders are largely exempt.

Mortgage brokers are just one participant in a larger network of loan originators – including mortgage bankers, mortgage lenders, credit unions, and depository institutions – all competing to deliver mortgage products to consumers. There are actually very few substantive differences between these distribution channels when it comes to originating mortgages. The lines that once divided them have become increasingly blurred with the proliferation of the secondary mortgage market. Today, mortgage brokers and mortgage lenders are performing essentially the same function – they present an array of available loan products to the consumer, close the loan and then, almost instantaneously sell the loan to the secondary market (i.e., Fannie Mae or Freddie Mac).

Although consumers are often unable to distinguish one origination source from another, mortgage brokers stand singularly accused of operating on an unregulated basis. This accusation is plainly false. Mortgage brokers are regulated by more than ten federal laws, five federal enforcement agencies and at least forty-nine state regulation and licensing statutes. Moreover, mortgage brokers, who typically operate as small business owners, must also comply with a number of laws and regulations governing the conduct of commercial activity within the states.

Federal Regulation of Mortgage Brokers

Mortgage brokers are governed by a host of federal laws and regulations. For example, mortgage brokers must comply with: the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), the Home Ownership and Equity Protection Act (HOEPA), the Fair Credit Reporting Act (FCRA), the Equal Credit Opportunity Act (ECOA), the Gramm-Leach-Bliley Act (GLBA), and the Federal Trade Commission Act (FTC Act), as well as fair lending and fair housing laws. Many of these statutes, coupled with their implementing regulations, provide substantive protection to borrowers who seek mortgage financing. These laws impose disclosure requirements on brokers, define high-cost loans, and contain anti-discrimination provisions.

Additionally, mortgage brokers are under the oversight of the Department of Housing and Urban Development (HUD) and the Federal Trade Commission (FTC); and to the extent their promulgated laws apply to mortgage brokers, the Federal Reserve Board, the Internal Revenue Service, and the Department of Labor. These agencies ensure that mortgage brokers comply with the aforementioned federal laws, as well as small business and work-place regulations such as wage,

Appendix B

hour and overtime requirements, the do-not-call registry, and can-spam regulations, along with the disclosure and reporting requirements associated with advertising, marketing and compensation for services.

Mortgage Broker Regulation in the States

The regulation of mortgage brokers begins at the federal level, but it certainly does not end there. Mortgage brokers are licensed or registered and must comply with pre-licensure and continuing education requirements and criminal background checks in forty-nine states and the District of Columbia. Additionally, over half of these states require not only mortgage broker licensure, but the licensure or registration of brokers' individual loan officers as well. An increasing number of states are requiring these originators to pass tests in order to become licensed. The same is not true for the thousands of loan officers employed by mortgage bankers and other lenders, who are exempt in most states from loan officer licensing statutes. While the Office of the Comptroller of the Currency exempts depository institutions from state licensing requirements, the states continue to increase their regulation of mortgage brokers and their individual loan officers. Many states also exempt lenders from licensing if they are approved by Fannie Mae or HUD, which subjects those lenders and their employees to significantly less regulation than most mortgage brokers.

As small businessmen and women, mortgage brokers must also comply with numerous predatory lending and consumer protection laws, regulations and ordinances (i.e., UDAP laws). Again, this is not true for a great number of depository banks, mortgage bankers, mortgage lenders and their employed loan officers, which remain exempt due to federal agency preemption. Many states also subject mortgage brokers to oversight, audit and/or investigation by mortgage regulators, the state's attorney general, or another state agency, and in some instances all three.

Conclusion

The mortgage industry is heavily regulated at both the state and federal levels; yet no amount of law or regulation will ever completely eliminate abusive practices from this or any industry. Placing additional restrictions on legitimate and law-abiding originators will not successfully address the problem of the truly unscrupulous lenders who brazenly ignore the laws as they currently exist. It is only through the enforcement of existing laws and the application of uniform legal standards to all originators that a lending environment will be created where consumers are free to shop and compare mortgage products and pricing among different distribution channels without fear or confusion.

Many of the current state and federal proposals to address abusive lending practices will simply not prevent predatory and abusive lending practices from occurring. Instead, these proposals could actually harm the consumer by restricting the choices of loan products, terms, and originators available in the market. Because each distribution channel is competing for consumers' mortgage loan business, consumers are best served when every mortgage originator is held to the same professional standards under the law.

Appendix C

US Department of Housing and Urban Development

Uniform Good Faith Estimate Statement

Name and Address of Borrower	Originating Company Name and Address: Loan #:__________
Property Address:	**Proposed Interest Rate: ____ % Term of the loan: Years** **Proposed Loan Amount: $** **Program Type:☐ Conventional; ☐ FHA; ☐ VA; ☐ Other:** **☐ Fixed Rate Mortgage Loan, or ☐ Adjustable Rate Mortgage Loan** **Prepayment Penalty: ☐May; ☐May Not Balloon Payment: ☐ Yes; ☐ No**

Settlement Charges:

800: Items Payable in Connection With The Loan:	
801: Loan Origination Fee (%) to:	
802: Loan Discount Fee (%) to:	
803: Appraisal Fee to:	
804: Credit Report Fee to:	
805: Lender's Inspection Fee to:	
806: Application Fee to:	
807: Flood Certification Fee to:	
808: Mortgage Broker Fee (%)	
809: Tax Service Fee to:	
810: Processing Fee to:	
811: Underwriting/Admin Fee to:	
812: Wire Transfer Fee to:	
813:	
900: Items Required By Lender To Be Paid In Advance	
901: Interest for ___ days at $ ___ /day	
902: Mortgage Insurance Premium for ___ mos. to ______	
903: Hazard Insurance Premium for ___ mos. to ______	
904: Flood Insurance Premium for ___ mos. to ______	
905: VA Funding Fee / Mortgage Insurance Premium	
1000: Reserves Deposited with Lender: Waived ☐Yes ☐No	
1001: Hazard Insurance: ___ months @ $ ___ per mo.	
1002: Mortgage Insurance: ___ months @ $ ___ per mo.	
1003: City Property Taxes: ___ months @ $ ___ per mo.	
1004: County Property Taxes: ___ months @ $ ___ per mo.	
1005: Annual Assessments: ___ months @ $ ___ per mo.	
1006: Flood Insurance: ___ months @ $ ___ per mo.	
1007: months @ $ per mo.	
1008:	
1100: Title Charges	
1101: Settlement or Closing/Escrow Fee to:	
1102: Abstract or Title Search to:	
1103: Title Examination to:	
1104: Title Insurance Binder to:	
1105: Documentation Preparation to:	
1106: Notary Fees to:	
1107: Attorney's Fee to: (Includes above item numbers: ______)	
1108: Title Insurance Fee to: (Includes above item numbers: ______)	
1109: Lender's Coverage $	
1110: Owner's Coverage $	
1111: Includes Commitment Fee to.	
1112: Endorsement Fee to	
1113: Wire Fee to:	
1114: Electronic Doc Fee to:	
1115: Courier Fee to	
1116:	
1117:	
1118:	
1200: Government Recording and Transfer Charges	
1201: Recording Fees: ☐Deed $ ☐Mortgage $ ☐Release(s)/Reconveyance(s) $	
1202: City/County Tax/Stamps: ☐Deed $ ☐Mortgage$	
1203: State Tax/Stamps: ☐Deed $ ☐ Mortgage $	
1204: Assignment Fee to:	
1205 Subordination Fee to:	
1300: Additional Settlement Charges	
1301 Survey to	
1302: Pest Inspection Fee to:	
1303: General Inspection(s) to:	
1304: Home Warranty Fee to:	
1305: Elevation Certificate Fee to:	
A: Settlement Cost (Sections 800, 1100, 1200, 1300 above) **B: Prepaid Items (Sections 900 and 1000 above)**	
1400: Total Estimated Settlement/Closing Costs	

Summary of the Borrower's Transaction:

Contract Purchase Price	
Existing Loan Amount to be Paid Off	
Personal Property	
Total Settlement/Closing Cost Charges to Borrower(s): **1400 A**	
Total Pre-Paids/Reserves Charged to Borrower(s): **1400 B**	
Gross Amount Due From Borrower(s):	
<Deposit of Earnest Money>	( )
<Principal Amount of new loan(s)>	( )
<Seller Paid Closing Cost Credit(s)>	( )
<Subordinate Loan Proceeds>	( )
<Other Credit(s)>	( )
Amounts Paid By or In Behalf of Borrower(s):	( )
Cash at Settlement Due From/To Borrower(s):	
Proposed Payment(s):	
1st Mortgage: ☐Principal & Interest pmt ☐ Interest Only pmt	
2nd Mortgage: ☐Principal & Interest pmt ☐ Interest Only pmt	
Property Taxes	
Home Owners Insurance	
Private Mortgage Insurance	
Homeowners Association Dues	
Other	
Other	
Total Proposed Monthly Payment:	

Nature of Relationship: In connection with this residential mortgage loan, you the Borrower(s), has/have requested assistance from ____________________ (Company name) in arranging credit. We do not distribute all products in the marketplace and cannot guarantee the lowest rate.

Termination: This agreement will continue until one of the following events occur:

1. The Loan closes
2. The Request is denied.
3. The Borrower withdraws the request.
4. The Borrower decides to use another source for origination.
5. The Borrower is provided a revised Uniform Good Faith Estimate Statement.

Notice To Borrower(s): Signing this document does not obligate you to obtain a mortgage loan through this mortgage originator; nor is this a loan commitment or an approval; nor is your interest rate locked at this time unless otherwise disclosed on a separate Rate Lock Disclosure Form. Do not sign this document until you have read and understood the information in it. Fees received under this estimate are legal and permissible under the Real Estate Settlement and Procedures Act. You will receive a re-disclosure of any increase in interest rate or if the total sum of disclosed settlement/closing costs in **Section 1400A** increase by 10% or more of the original estimate. Should any such increase occur; mandatory re-disclosure must occur prior to the settlement or close of escrow.

Applicant(s) hereby acknowledge(s) the receipt of a copy of this Good Faith Estimate and that you/they inquired into real estate mortgage financing with ____________________ (Company) on ____________ (date).

Borrower: ____________________ **Co-Borrower:** ____________________

____________________ ____________________

Originator **Date** **License # (if applicable)**

GFE ver.1.2

Appendix D

NAMB
National Association of Mortgage Brokers

Model State Statute Initiative

Licensing, Pre-licensure Education and Continuing Education Requirements for All Originators

NAMB proposes a state statute initiative to protect consumers and ensure originator competency.

June 2002
Amended January 2005

The National Association of Mortgage Brokers (NAMB) is the national trade association representing the mortgage broker industry. With 49 state affiliates and more than 27,000 members, NAMB promotes the industry through programs and services such as education, professional certification and government affairs representation. NAMB members subscribe to a code of ethics and best lending practices that foster integrity, professionalism and confidentiality.

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Acknowledgements*

This Model State Statute Initiative is the result of a consensus process involving the Model State Statute Task Force, the NAMB Board of Directors and the NAMB Delegate Council and many internal committees.

NAMB wishes to thank President Joseph L. Falk, CMC, CRMS, for his leadership and commitment in proposing and promoting this major consumer protection initiative.

The Model State Statute Task Force provided inspirational leadership in developing the concepts and articles to be included in this Initiative. Thank you Mitch Medigovich, CMC, Leo Davenport, CRMS and Kate Crawford for your many hours of service and your clear thinking and thoughtfulness throughout the deliberative process.

Thank you to the Communications Committee, chaired by Al Wood, CRMS, NAMB's public relations firm of Merton G. Silbar Public Relations, Natalie Bachiri, NAMB's Director of Communications, NAMB's management firm, Association Management Group, as well as NAMB's legal counsel Robert Lotstein and staff of the firm of Lotstein Buckman.

The Legislative Committee, chaired by J.J. Sims and the Education Committee, chaired by Carol Gardner, CMC, CRMS, contributed mightily to the end product using their committee structure, committee members and other individuals to add to this national initiative.

We would also like to acknowledge and thank the NAMB Board of Directors and Delegate Council who have endorsed this proposal for protecting mortgage consumers.

* As of June 2002

Contents

Model State Statute Initiative

National Association of Mortgage Brokers

June 2002

Dear Mortgage Professional:

Buying or financing a home is one of the largest, most complicated and vitally important decisions facing consumers in the United States. Therefore, residential mortgage loan originators who work directly with the public should be educated, honest and professional.

The National Association of Mortgage Brokers is proud to announce a comprehensive initiative to better serve and protect the public through increased licensure, training and education of all residential mortgage originators. The NAMB Model State Statute Initiative is based on NAMB's firm belief that part of the solution to consumer abuse and predatory lending is mandatory licensing and education of all residential loan originators.

NAMB is taking a proactive stance on consumer protection. This model statute serves as a model for state regulators and legislators whose states do not have such statutes or whose states need to improve their statutes to protect and serve the general public.

The concept has four basic tenets:

a) It should apply to all residential mortgage loan originators
b) There should be a state licensing requirement
c) There should be a pre-licensure education requirement
d) There should be a continuing education requirement to maintain competency

Our 44 state affiliates, which comprise NAMB, support this initiative and recommend that specific concepts for licensure and education be considered based on each state's current statute(s). NAMB recognizes that some states have aggressively monitored the industry through licensure and others have made education mandatory; whereas other states have determined different levels of oversight to regulate the mortgage industry.

While each state is different, NAMB believes that this initiative will serve to help reduce the incidence of predatory lending and improve the overall competency of the industry in every state. NAMB urges each state to adopt these concepts in the best interest of the public. NAMB is committed to see this matter through to fruition and will monitor the progress of this initiative in each state.

Our state affiliates will now lead the charge to protect consumers through enhanced licensing, pre-licensure and continuing education proposals to their respective state legislatures and mortgage regulators.

Thank you for your support of this proposal for State Licensure, Pre-licensure Education and Continuing Education for all originators.

Sincerely,

Joseph L. Falk, CMC, CRMS
President

NAMB
National Association of Mortgage Brokers

NAMB Model State Statute Initiative

Goal: To better serve and protect the public, the residential mortgage loan industry will endeavor to license, train and educate all residential mortgage originators. NAMB firmly believes that part of the solution to consumer abuse and predatory lending is mandatory licensing and education of all residential loan originators.

Concept: Buying or financing a home is one of the largest, most complicated and vitally important decisions facing consumers in the United States. Residential mortgage loan originators who work directly with the public should be educated, honest, and professional.

Overview: NAMB is taking a proactive stance on consumer protection. NAMB seeks to have individual state statutes enacted that require pre-licensure education and mandate continuing education requirements for all residential loan originators. This model statute would serve as a model for state regulators and legislators whose states do not have such statutes or whose states need to improve their statutes to protect and serve the general public.

The concept has several basic tenets:

a) **It should apply to all residential mortgage loan originators**
b) **There should be a state licensing requirement**
c) **There should be a pre-licensure education requirement**
d) **There should be a continuing educations requirement to maintain competency**

NAMB believes that such an initiative will serve to help reduce the incidence of predatory lending and improve the overall competency of the industry. NAMB urges each state to adopt these concepts in the best interest of the public. NAMB is committed to see this matter through fruition and will monitor the progress of this initiative in each state.

All residential mortgage loan originators should have formal training and should be tested on their knowledge of matters including financial analysis, ethics, federal and state disclosures, real estate law, and mathematical computations germane to real estate and mortgage lending prior to contact with the public. Residential Mortgage Loan Originators should be well qualified before they work with homeowners on mortgaging or financing their most valuable asset.

For this reason, NAMB recommends and supports a standardization of education and experience for every person who holds themselves out to the public to be a Residential Mortgage Loan Originator.

Licensing Overview

We believe that each state should enact a licensing requirement for all residential mortgage loan originators. The requirements for licensure should encompass all residential mortgage loan originators and all owners or responsible individuals of residential mortgage loan entities.*

Residential Mortgage Loan Officer Shall be defined as any individual who, for compensation or gain, takes or receives a mortgage application, assembles information, and prepares paperwork, and documentation necessary for obtaining a residential mortgage loan, or arranges for a conditional mortgage loan commitment between a borrower and a lender, or arranges for a residential loan commitment from a lender. Residential Mortgage Loan Officers also include an employee who solicits financial and mortgage information from the public for sale to another residential mortgage broker.

Principal Mortgage Owners/ Responsible Individual Defined as the owner, or managing general partner, or responsible individual, or any Officer, or stock holder, who holds themselves out to be the party accountable for residential mortgage loan originations or branch mortgage operations, with in the state, and/or the person in direct management of residential mortgage loan origination.

Exempt Any individuals who do not deal (i.e. negotiate interest rates, loan programs, offer loan locks, loan commitments) directly with borrowers. This includes persons who complete incidental services in arranging or procuring a mortgage loan, including administrative staff wherein their primary function is the verification of data provided by the borrower, assembly of documents and coordination of third party services such as ordering an appraisal, title report or credit reports.

Anyone who deals directly with a consumer and reviews, analyzes, evaluates a proposed borrowers financial statements, income, property characteristics and credit history should obtain a license.

Licensing Requirements

To obtain a state license to become a residential mortgage loan originator, the following concepts should be adopted:

1. A written application for licensure must be required. The application should require an attestation by the applicant as to the applicant's experience and knowledge of the mortgage industry.

2. The applicant should submit to a background investigation of, at a minimum, criminal records, and employment history.

   - No individual should be licensed who has had a license, or the equivalent, to practice any profession or occupation revoked, suspended or otherwise who has acted beyond legal limits.

   - No person should be licensed who has been convicted of acts against society that could be deemed 'moral turpitude'. Such acts where licenses should be denied must include duties owed by licensees to the public including acts contrary to justice and the doctrine of "fair dealing", honesty, principle or good business morals. This includes, but is not limited to theft, extortion, use of the mail to obtain property under false pretenses, tax evasion and the sale of, or the intent to sell controlled substances.

   - The licensee should provide evidence that they have managed their business and personal financial affairs with care and diligence.

3. A first time Residential Mortgage Loan Officer Licensee Applicant shall provide a certificate of satisfactory completion of a course of study, as defined by the state, consisting of the subjects listed below.

4. A Principal Mortgage Lending Entity/Owner/Responsible party Licensee Applicant shall provide a certificate of satisfactory completion of a course of study, as defined by the state, consisting of course work from the subjects listed below.[1]

5. A Licensee Applicant shall pass an examination of the applicant's knowledge after items 1-4above have been completed.

6. Licenses shall be valid for a two-year period. Upon expiration of the two-year period, the licensee should submit an application for renewal to the appropriate licensing authority. The renewal application should, at a minimum, include evidence of completion of continuing education courses, as described below.

7. The licensing authority should have the authority to request additional information from the Licensee Applicant to support statements made on the application or dispute matters discovered through investigation.

8. All initial applicants shall submit a finger print card, which shall be forwarded to the local Department of Public Safety and/or FBI for a records check.

9. The Licensee Applicant shall pay sufficient fees to pay for Licensing Authorities' costs of processing the license application and investigations.

10. Upon receipt of a Residential Mortgage Loan Officers license, the licensee shall immediately deliver the license to his/her employing broker. Upon termination of employment of a Residential Mortgage Loan Officer, the license shall be transferred to a new employing broker and the regulating authority should be notified. If the Residential Mortgage Loan Officer does not have a new employing broker, the license shall be returned to the Licensing Authority with an explanation or the reasons for termination.

11. The appropriate state regulatory authorities should maintain state licensing or registration records.

Grandfathered Persons

Every Residential Mortgage Loan Officer, currently registered, licensed or otherwise employed in the mortgage industry immediately preceding enactment of this initiative shall be permitted to continue employment as a Residential Mortgage Loan Officer. Each current originator shall be required to meet all of the necessary elements of licensure at the next renewal period specified by state law.

Unless provided for in state law, every Principal Residential Mortgage Lending Entity or Owner, currently licensed immediately preceding enactment of this initiative shall be permitted to maintain their license and position. Each current Principal Residential Mortgage Lending Entity/Owner shall be required to meet all of the necessary elements of licensure at the next renewal period specified in the state law.

[1] Based upon the experience of many mortgage brokers, the educational requirement should be greater than that required of Residential Loan Officers.

Pre-Licensing Education

All persons making an initial application for licensing must:

a) Attend educational courses, determined by the state, when applying for a Residential Loan Officer license;
b) Attend educational courses, determined by the state, when applying for a Principal Mortgage Owner license;
c) Pass a test of core competencies;
d) Receive a certificate of completion from the school or organization that provided courses.

Each State or Licensing Authority should, with the assistance of the local mortgage professionals, establish review and approve curriculum sufficient to establish a baseline of knowledge for licensees.

Recommended Course Curriculum Pre-licensure course curriculum may include:

a. Federal Lending Laws;
b. Ethics, Diversity and Sensitivity;
c. Practices of Residential Lending.
d. Real Estate and Mortgage Mathematics;
e. Escrow Procedures, Title Insurance and Loan Settlement;
f. Appraisals and Land Survey;
g. Loan Processing and Loan Underwriting Process;
h. Secondary Mortgage Market;
i. Loan Default and Foreclosure Law;
j. State Statutes and Rules.

Continuing Education Requirements

Every residential mortgage originator, whether a Residential Loan Officer or Principal Mortgage Owner, shall, upon renewal of an existing license, submit proof of satisfactory completion of a course of study.

Subjects may include:

a) Federal and State Lending Law;
b) Local Rules and Regulations;
c) Ethics and Professional Standards;
d) General Real Estate or General Financial Studies;
e) Product Update;
f) Personal Development;
g) Diversity Training.

Continuing education courses may be offered through classroom instruction, electronic transmission, or distance learning. Qualifying hours may be obtained by attendance at a locally chartered real estate or mortgage business school, accredited college, university or community college, or vocational school or other institution approved by the state licensing agency.

The licensee should receive a completion certificate that such hours have been successfully completed. Licensees shall submit the appropriate completion certificate(s) with the license renewal form.

Conclusion

It is the intent of this initiative to engage measures to reduce the incidence of predatory lending and to raise the standards for those persons who interact with the public in the area of home financing. Every Residential Loan Originator should be licensed, responsible and accountable for his or her actions when working with the public. We at NAMB believe that establishing minimum educational requirements as well as requiring continuing education will substantially increase each Residential Loan Originator's awareness of their responsibility and duty to give consumers fair and honest service. It may be desirable for each state to consider establishing a mortgage oversight board to assist the commissioner with up-to-date material for pre-licensing and continuing educational courses.

*This initiative contemplates using the words 'license' and 'registration' interchangeably. We leave to the States to determine if this process includes an individual license, permit or an aggregated corporate registration methodology, so long as both aspects of educational requirements are maintained and criminal background investigations and prohibitions are maintained. If a corporate registration of all originators is contemplated, it should require 'employee' status and a bonding requirement should be considered. It is understood that if such a corporate methodology is utilized, paragraph 10 under Licensing Requirements is not applicable.

Recommended Course Curriculum

Pre-licensure course curriculum may include:

I. Federal Lending Laws. Licensees should develop competencies in matters of federal mortgage statutes, which may include:

a) Regulation Z, Truth in Lending Act;
b) Real Estate Settlement Procedures Act (RESPA);
c) Regulation B, the Equal Credit Opportunity Act;
d) Regulation C, the Home Mortgage Disclosure Act;
e) National Flood Insurance Act;
f) Fair Credit Reporting Act;
g) Federal Trade Commission rules concerning advertising for credit;
h) Servicing Transfer Act;
i) Privacy Act;
j) Consumer Protection Act;
k) Community Reinvestment Act.

II. Ethics, Diversity and Sensitivity. Licensees should be able to discuss the canons of:

a) Fair Housing Act;
b) Emerging Markets;
c) Redlining and Block-busting;
d) Ethical practices of mortgage lending.

III. Practices of Residential Lending. Licensees shall develop competencies in the subjects of:

a) Evolution of Residential Lending in the United States
b) The role of Government Sponsored Enterprises (GSE's)
c) Federal National Mortgage Association
d) Government National Mortgage Association
e) Federal Home Loan Mortgage Corporation
f) Federal Housing Administration
g) Veteran's Administration
h) Farmers Home Administration
i) Private Mortgage Insurance Industry Principles of Mortgage Lending, including but not limited to:
j) Assisting consumers in selection of loan programs including adjustable rate loans;
k) Evaluating the relationship between discount points and interest rates;
l) Describing the costs of originating a mortgage loan;
m) Preparing and discussing the required state and federal disclosures with a consumer;
n) Interpreting and discussing loan contingencies and covenants with the consumer;
o) Explaining the loan commitment issued by a lender;
p) Reading and understanding a real estate contract as it relates to financing of real property;
q) Identifying methods of holding title to real estate and discuss options with the consumer;
r) Describing the advantages of primary and subordinated financing options;
s) Explaining and preparing a Good Faith Estimate of costs for a consumer.

IV. Real Estate and Mortgage Mathematics. Licensees should develop competencies in basic mathematics.

The licensee should have the basic skills to:

a) Calculate gross and net loan amounts to satisfy a consumers loan request;
b) manually prepare a Good Faith Estimate of costs and Truth in Lending statement;
c) calculate and analyze ratios of mortgage payment-to-income;
d) calculate the ratio of total obligations-to-income to determine loan acceptability;
e) analyze income tax returns for self-employed borrowers to confirm sufficient income;
f) calculate loan to value ratios;
g) calculate origination fees, yield spread premiums and discount points;
h) calculate prorations for real estate taxes and insurance amounts for the reserve account;
i) calculate rate changes on adjustable rate mortgages;
j) convert hourly and weekly salaries to monthly income to compute ratios;
k) determine that the consumer has sufficient funds for closing;
l) calculate monthly principal and interest payments and the amortization of a loan;
m) calculate per diem interest amounts;
n) manually calculate the Annual Percentage Rate
o) describe the theory of Time Value of Money and the impact on the financing contract.

V. Escrow Procedures, Title Insurance and Loan Settlement. Licensees should develop competencies in matters of closing forms and the closing process. The licensee should be able to explain the documents and process so that the borrower fully understands what is taking place.

The documents to be explained include, but are not limited to:

a) the mortgage note and its provisions for default, the lenders rights and the borrowers rights;
b) the security agreement, (mortgage or deed of trust), including each of the covenants and conditions;
c) the HUD-1 closing statement and its relationship to the Good Faith Estimate of Costs;
d) the Good Faith Estimate of costs and final Truth in Lending statement;
e) the consumers right of rescission.
f) the purpose and cost of lenders title insurance;
g) the purpose and cost of owners title insurance;
h) title examination;
i) title abstract;
j) lien theory;
k) Schedule "B" exceptions to title insurance

VI. Appraisals and Land Survey. The licensee should be able to describe:

The three methods of valuation, including:
- cost approach;
- market approach;
- income Approach;

a) the theory of economic obsolescence;
b) the theory of functional obsolescence;
c) the theory of depreciation;
d) the theory of depletion;

e) the Rectangular Survey System;
f) the method of legal identification of real property in their state;
g) calculate the number of acres in a given area;
h) calculate the number of square feet in a given area.

The licensee should be able to understand and communicate with the borrower the purpose and process of the appraisal, the survey, title insurance, restrictive covenants, deed restrictions, and encroachments and pest inspections.

VII. Loan Processing and Loan Underwriting Process. Licensees should study the subjects of loan processing and underwriting. After study in this section, the licensee should be able to:

a) prepare, explain, and execute a business agreement with the consumer;
b) demonstrate the ability to understand and explain an FNMA 1003 mortgage application;
c) explain requirements for determining if the property, income and credit of borrower fit the loan offerings available through the licensee.

The licensee should have the knowledge to collect the necessary exhibits anticipated for:
a) underwriting contingencies;
b) understanding the procedures and requirements for issuing adverse action notices;
c) assembling for submission an entire loan package for underwriting.
d) evaluation of an appraisers conclusions.

The licensee should also have a basic knowledge of:
a) negotiating a rate lock;
b) investigation and confirmation of application data;
c) arranging for a property inspection;
d) evaluating and reviewing a title insurance policy;
e) owner's versus mortgagee's title insurance policies;
f) the function and operation of private mortgage insurance and knowing when it is required;
g) when private mortgage insurance can be canceled;
h) the meaning of the terms novation, assumption, and "subject to the mortgage";
i) release of liability.

The licensee should be able to demonstrate an understanding of the basics concepts of:
a) fixed versus variable rate mortgage loans;
b) negative and positive amortization principles;
c) graduated payment mortgages;
d) reverse mortgages;
e) shared appreciation mortgages;
f) bi-weekly mortgages;
g) temporary and permanent interest rate "buy-downs";
h) the concept of a wraparound mortgage.

VIII. Secondary Mortgage Market. Licensees should study the process of the secondary market. The licensee should be able to describe:

a) how interest rate markets are established;
b) interest rate risks;
c) the theory of "yield spread premiums";
d) the theory and process by which loans are sold;
e) the theory and purpose of a loan purchase commitment;
f) FNMA and FHLMC standard eligibility requirements;
g) the function and method of operation of FNMA, GNMA and FHLMC;
h) the method and marketing aspects of a GNMA mortgage-backed pass-through security;
i) the theory of "service release premiums".

The licensee should also be able to explain the basic functions of;
a) mortgage servicing;
b) collections;
c) remittance of payments;
d) escrow accounts for taxes and insurance;
e) payoffs ;
f) assumptions;
g) the transfer of servicing rights.

IX. Loan Default and Foreclosure Law. Licensees should study Foreclosure Law. Licensees should be able to describe:
a) the type of foreclosure law most frequently used in their state;
b) the legal process of a judicial foreclosure;
c) the legal process of a trustee's sale and how it differs from a judicial foreclosure;
d) the borrower's rights of reinstatement;
e) the borrower's right of redemption;
f) the legal process of a forfeiture of equitable title;
g) the effects of subordinate liens after foreclosure;
h) the effects of mechanics and materialmens' liens;
i) the process of tax lien sales.

X. State Statutes and Rules. Licensees should study of State and local law. Licensees should be able to identify:
a) minimum record keeping requirements;
b) record retention requirements;
c) minimum requirements for licensing;
d) the process for examination of a licensees records;
e) standards for accounting;
f) standards for maintaining Trust Funds;
g) minimum net worth requirements;
h) minimum bonding requirements;
i) local disclosure requirements;
j) contracts and written agreements with consumers;
k) minimum requirements for supervision of employees;

NAMB®
National Association of Mortgage Brokers

The National Voice of the Mortgage Broker

Established in 1972, the National Association of Mortgage Brokers (NAMB) is the national trade association representing the mortgage broker industry. With 49 state affiliates, and more than 27,000 members, NAMB promotes the industry through programs and services such as education, professional certification and government affairs representation. NAMB members subscribe to a code of ethics and best lending practices that foster integrity, professionalism and confidentiality.

A mortgage broker is an independent real estate financing professional who specializes in the origination of residential and/or commercial mortgages. There are approximately 33,000 active mortgage broker operations across the nation that employ an estimated 240,000 people and originate 65% of all residential loans in the U.S.

A mortgage broker is also an independent contractor who markets and originates loans offered by several wholesale lenders. By offering superior market expertise, and direct access to many different loan programs, a mortgage broker provides the consumer the most efficient and cost-effective method of obtaining a mortgage that fits the consumer's financial goals and circumstances. Mortgage brokers originate more mortgages than any other single loan source group in this nation.

The brokerage industry plays a significant role in the mortgage lending process and American economy, increasing competition and driving down costs. The expansive mortgage broker network allows loan wholesalers of all sizes to immediately gain a national presence without incurring the great expense of national advertising and maintenance of branch offices.

The mortgage broker industry is regulated by 10 federal laws, five federal enforcement agencies and over 45 state laws or licensing boards. Additionally, brokers typically have some type of Quality Control requirements and NAMB members also adhere to a strict Code of Ethics and best lending practices.

AARP

Written statement
before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

on

"PRESERVING THE AMERICAN DREAM: PREDATORY LENDING PRACTICES AND HOME FORECLOSURES"

7 February 2007

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Chairman Dodd, Ranking Member Shelby, and members of the Committee, thank you for the opportunity to share our experiences and concerns about the growing problem of mortgage foreclosure in this country. Over the past fifteen years, AARP and AARP Foundation have been representing older homeowners facing foreclosure on abusive mortgage loans. The accumulated home equity and limited incomes of older homeowners have made them a primary target of predatory lending.

Fair and affordable financing is key to maintaining the dramatic increase in U.S. homeownership in the last decade, which reached a new high of 69% in 2004. It is especially important to sustain homeownership gains for those traditionally underserved, including low-income and minority communities. AARP is concerned that this record level of homeownership is at risk, however, as substantial numbers of homeowners experience problems with home mortgages. The key problem, which we are here to discuss today, is unsustainable loans made through predatory lending practices.

Today, many predatory loans are offered that target the most vulnerable Americans, including the elderly. We are very concerned that the current combination of minimal underwriting standards and exotic and complex mortgage products has created a perfect storm that is driving and will continue to drive homeowners into foreclosure. Allow me to give you three examples that illustrate our concerns and then review some measures we see as solutions to the most pressing problems.

The first case is from 1992, when we represented Mr. Pittman, an 82-year-old man on the verge of foreclosure. He had been a shoe salesman during his working years when he and his wife were able to purchase a modest home. Owning his home was perhaps the greatest single joy and source of pride in Mr. Pittman's life. His incompetence in later years, following the death of his wife, made him easy prey for predatory lenders. Mr. Pittman's mortgage had been paid off for eight years when he was offered a refinance by a broker that charged him 16 points on a $60,000 loan at a 17% interest rate. His mortgage payment was $800/month – the same as his total monthly income from Social Security and his small pension. The mortgage was starkly unaffordable and was typical of the subprime mortgages in the market prior to the passage of the Home Ownership and Equity Protection Act (HOEPA) in 1994. Since enactment of HOEPA, that picture has changed; HOEPA has had its intended effect of driving these bad products out of the market.

But HOEPA has not been entirely successful in curbing predatory mortgage lending practices, as my second example will show. In 1999, after HOEPA had been in effect for several years, we represented ten elderly and unsophisticated District of Columbia homeowners in a consolidated predatory lending case against a single lender. While a few of these homeowners had HOEPA loans, the points, fees, and interest rates on most of their mortgages squeaked just under the HOEPA thresholds. All had one thing in common: none could afford their mortgages.

They had worked all their lives in working-class jobs – in the cafeteria at NIH, on the cleaning crew at the Library of Congress, in various custodial jobs. Each had struggled to buy their homes, and most had raised children in them. When we met these elderly homeowners, they were in failing health. They were all retired – on Social Security, and perhaps a small pension. A few supplemented their income with small jobs: Mrs. Duncan, a 76-year-old Jamaican immigrant, received a small monthly check for doing in-home care for a mentally disabled woman; Mrs. Pittman did a little babysitting on the side. Imagine the surprise of AARP attorneys when, in reviewing the clients' loan documents, we discovered "self-prepared" tax returns that identified these folks as self-employed bookkeepers, accountants, and seamstresses. One gentleman, an 86-year old stroke victim in a wheelchair, had a tax return that described him as a computer programmer who made $30,000 a year.

As the case progressed, it became clear that the broker and lender had worked together to fabricate these tax returns to make it appear that our clients could afford mortgages whose monthly payments, in some cases, exceeded their incomes. Because our clients had owned their homes for decades, they had equity, and that was all the lender cared about. When we met them, they were all in default or had refinanced out of these mortgages into other, equally unaffordable ones.

In working on that case, AARP attorneys wrestled with the cause of these practices. We believed that the large banks that bought these mortgages could have easily prevented their origination if they had simply followed their own underwriting guidelines and done proper due diligence. Developments in recent years have forced us to see the stark reality—following underwriting guidance alone does not prevent the issuance of predatory loans, but this is not the case. In fact, predatory loans are consistent with today's underwriting policies, when they are used at all.

Historically, you may recall, mortgage applicants were required to establish their ability to repay with W-2s, tax returns, bank statements, or other verifications of income. I have vivid memories of applying for our first mortgage and worrying about whether we could establish that we met the 28% mortgage debt-to-income ratio that was the industry standard at that time. All of that has changed dramatically in the past few years.

The secondary market, which now controls the types of mortgage products offered and the underwriting standards that are applied, has made widely available what are called "stated income" and "low documentation" or "no documentation" mortgages. These mortgages require little or no verification that the borrower has the income necessary to repay the loan. The most recent innovation in this area is called the "no income, no asset" (NINA) loan. NINA loan applicants are not even *asked* to state, much less to *verify*, their income or assets. The income section of the loan application is simply left blank.

Industry representatives claim that these reduced documentation mortgages are useful to people who are self-employed or who want to qualify quickly. But they are harmful and predatory when abused – which is happening today. They are, we should add, much more expensive for the borrower and often more lucrative for the originators.[1] Research conducted for the Mortgage Bankers Association has revealed that these products, while "speeding up the approval process . . . are open invitations to fraudsters." In a sample of 100 stated income loans, the researchers found that almost 60% of the stated income amounts were inflated by more than 50%.[2] Even if there is a place for these loans in some specialized niches in the market, how can these products be responsibly used for a homeowner whose entire income comes from Social Security payments? And why would they be offered to salaried applicants whose income is readily established? They present real and clear hazards that are contributing to foreclosures. This is illustrated in my last example, a case filed in December 2005 in Brooklyn, New York.

The case involves a property flipping scheme perpetrated by a group of property investors, lenders, appraisers, and attorneys. The case alleges that the group conspired to sell our clients, all of whom were first-time home buyers, damaged houses that had been bought cheaply, cosmetically repaired, and rapidly resold at vastly inflated prices. Our clients' six homes were over-appraised by an average of $137,000.[3]

AARP attorneys could not fathom how our clients had qualified for mortgages on homes costing $315,000 to $419,000. Our investigation revealed that two of these homeowners were

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[1] "Tremors at the Door," by Vikas Bajaj and Christine Haughney, *New York Times*, 1/26/07. See http://www.nytimes.com/2007/01/26/business/26mortgage.html?ei=5070&en=83083063d35e59a7&ex=1170565200&adxnnl=1&pagewanted=print&adxnnlx=1170459278-cykqqyeg4X3kWYQaE0/sLw.

[2] 2006 Mortgage Asset Research Institute's (AMARI) Mortgage Fraud Case Report at 12.

deemed "qualified" for their mortgages using the "no income, no asset" guidelines and a third using stated income that was inflated by the lender. One had been a salaried employee of the New York City Housing Authority for many years and therefore had stable (though modest) income, with clear documentation showing that her income was too low for her to afford the loan they were offering. Another was in her 70s and living only on Social Security benefits. All had income that was readily verified. But the homes would not have been sold nor the mortgage origination and other fees generated if their *verifiable* incomes had had to be considered. These "stated income" and "no income, no asset" products are the ideal vehicle to relieve unscrupulous lenders and brokers of the need to fabricate documentation, as was done in the past.

And this was not the only problem. In order to make the deal work, the lender piled on the risks – putting these folks into not one, but two mortgages each, commonly called "piggyback" lending. The first mortgage provided 80% of the purchase price, and the second mortgage, charging a much higher interest rate, made up the remaining 15-20% needed to close the deal. This structure may make sense, for example, for a first-year associate in a large law firm who will be able to pay off the second mortgage fairly rapidly as his or her income or bonuses increase significantly over a few years. But in the case of our clients, for whom steep income increases were not foreseeable, the piggyback mortgages, which depended on unreliable appraisals, combined with NINA loans, were a recipe for disaster that set them up for the defaults that inevitably occurred.

As these examples illustrate, inability to repay is the hallmark of predatory lending and is the single common thread among all of our cases stretching over fifteen years. We are very concerned that the inability-to-pay issues just described and the proliferation of stated and no income products

[3]Appraisal fraud has contributed to the foreclosure problem to a significant, but as yet unmeasured, extent. The 2006 Mortgage Asset Research Institute's Mortgage Fraud Case Report finds that appraisal fraud had increased from 2001-2005 and that the current figures will likely prove over time to be understated. MARI Report at 8-9.

create exponentially increased risk for homeowners, especially when combined with the so-called exotic mortgage products. The Office of the Comptroller of the Currency (OCC) and other regulators have warned against the dangers of this kind of risk-layering in their non-traditional mortgage guidance.

There has been a proliferation of new and confusing mortgage products, including "2/28s" and "3/27s" which offer a low interest rate for just two or three years that increases dramatically for the remaining 28 or 27 years of the mortgage; interest-only mortgages[4]; and payment option adjustable rate mortgages (ARMs), some of which are promoted with a 1% "teaser" rate that typically applies only to the first month of the mortgage and that can only adjust dramatically up, never down.[5] To the extent lenders underwrite the income supporting these loans at all, they do so only based on the deceptively low payments calculated on the low initial rate, not on the payment that will be charged once the loan becomes fully amortized and certainly not on the maximum rate

[4] An interest-only mortgage is often structured with an initial fixed rate period during which time the homeowner pays only the interest owing on the mortgage and no principal. This arrangement reduces the payment amount during the initial period as compared with traditional fixed rate or adjustable mortgages, which require repayment of principal as well as interest. After the interest-only period, the mortgage rate becomes adjustable, typically higher than at the fixed rate, and both interest and principal are owing. Even when the interest rate does not increase, the payment will come as a shock, since the homeowner will now be required to repay principal over a period of 25 years instead of the original 30. For example, a traditional $200,000 mortgage at a fixed rate of 6% over 30 years would require a payment of $1199.10/month; an interest-only mortgage would require a payment of $1,000 for the first 5 years. Even at 6%, the payment would jump to $1288.60 in the 6th year. If, in addition, the rate increased to a modest 7.5% in the sixth year, the payment would be $1477.98. If $1199.10 was unaffordable to the consumer in the first place, those higher payments in the 6th and remaining years of the mortgage will create serious risk of default.

[5] Option ARMs, in theory, offer the homeowner the "option" to pick among a choice of payments. In reality, 70% of prospective homeowners select a credit-card-like, minimum payment option—currently as low as 1.5%—because it enables them to purchase a more expensive home. However, because the minimum payment amount (which is often less than the interest owing) only adjusts annually, while the interest rate adjusts monthly, this choice carries significant risks. A consumer who pays the minimum will face negative amortization and a constantly-rising principal balance of about 2.5% per year. Once the principal increases by a set amount—between 10-25%—the "minimum payment" deal is off and the consumer must immediately begin making fully amortizing payments, triggering real payment shock. For example, for a borrower who started out with a $200,000 mortgage with a 10% cap on principal, the mortgage will reset and become fully amortizing after 4 years with a principal balance of $220,000. An initial minimum payment of 1.5% or $690.24/month will rise to 7.5%/year or $921.79/month at the end of 4 years. At that point, the loan becomes fully amortizing. At 6% the payment would be $1394.09. At a modest increase to 7.5% the payment would rise to $1604.70.

that could be charged over the life of the mortgage. When these loans are originated without stating or documenting income, the result is just the kind of risk-layering the regulators have warned against.

Homeowners are often completely unaware that their conscientious payments based on "low introductory rates" are causing the balance on their mortgages to *grow* each month because the loans are negatively amortizing. These mortgages become a trap from which many homeowners never escape. The five-year prepayment penalties—often the norm for these mortgages—make it impossible for homeowners to refinance out of or otherwise avoid the complex series of "payment shocks" built into the mortgages. The trap has been fortified by the downturn in housing prices. Homeowners who have been able to escape foreclosure up to this point by repeatedly refinancing will have no further recourse. When the equity is gone, foreclosure is inevitable.

I cannot emphasize enough that this lack of underwriting standards is a disservice to the unsophisticated consumers who become the prey of predatory lending practices. These types of predatory loans strip equity from these hard-working Americans and set them up for failure. Requiring fair and accurate underwriting of prime and subprime loans is the first step in eliminating predatory mortgages and allowing these consumers to preserve their status as homeowners. Accurate underwriting will foster the development of a fairly priced subprime loan market.

Experience has taught that changes in the laws that regulate mortgage lending can improve the market for all. Immediately after HOEPA became effective, the number of loans above the HOEPA triggers plummeted; unfortunately, other abusive practices took their place. Our goal is to get ahead of this curve. AARP does not want homeowners to be caught in an endless "whack-a-mole" game, with the law always lagging behind the next wave of abusive practices. Our challenge is to find a way to address not only today's abuses but to think more comprehensively about how to make home mortgages safe and home ownership secure and sustainable.

In that vein, I wanted to share with you some of the policies that AARP believes should be put in place to curb today's abusive predatory lending practices, although these are by no means an exhaustive list of the policies we support. I also want to provide the caveat that predatory lenders may look for new practices that skirt whatever law is in place. Therefore, as effective as these policies may be in curbing today's egregious practices, we need to find a way to allow for new, innovative solutions to curb future abuses.

Of foremost importance is the need to require sensible underwriting policies that take into account a consumer's ability to make monthly payments based on all the terms of a loan. Underwriting should not be based not on the lower "teaser" rate, but should ensure that consumer has the ability to repay over the life of the loan. And remedies should be available for consumers when lenders falsify their income.

We also urge you to support the elimination of incentives for mortgage brokers and lenders to steer consumers into loans that are riskier than necessary or that charge excessive points and fees. For example, the inclusion of prepayment penalties in most subprime mortgages can serve as a *quid pro quo* for making expensive "yield-spread premium" payments to mortgage brokers, which increase the interest rate on the loan. Prepayment penalties, which can cost families thousands of dollars when they refinance or pay off their loans early, often are not accompanied by offsetting benefits to the borrower, such as a lower interest rate. Instead, they can serve as one way of stripping home equity or trapping borrowers in costly loans.

We also urge you to support accountability for abusive loan servicing. Abusive servicing can occur when loan servicers fail to promptly credit mortgage payments, resulting in unfair late fees and other charges to borrowers even when the payments are received on time. For example, a single late payment can lead to an escalating accrual of fees, month after month, even when the consumer has made all other payments on time. This occurs when each payment is credited first to the late fee and then to interest and principal, leading to multiple late charges for a single payment in arrears. Servicers should credit payments first to the principal and then to fees and other charges.

There are also a number of other policies that can help prevent predatory loans, such as a prohibition on mandatory arbitration clauses, further restricting or prohibiting balloon payments on loans covered by HOPEA, and strengthening assignee liability, among others.

In summary, today I have shed light on just a few of the egregious cases in the predatory lending market. More should be done to protect vulnerable home buyers from predatory practices, while leaving room for new policy solutions to deter future unscrupulous practices that will arise to skirt new consumer protections. AARP very much appreciates the Committee's work on this issue and looks forward to working with you to protect vulnerable consumers, particularly older homeowners, against predatory mortgage lenders.

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STATEMENT OF MR. HILARY SHELTON

DIRECTOR, NAACP WASHINGTON BUREAU

ON PRESERVING THE AMERICAN DREAM:

PREDATORY LENDING PRACTICES AND HOME FORECLOSURES

before the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

February 7, 2007

Good morning. My name is Hilary Shelton and I am the Director of the National Association for the Advancement of Colored People Washington Bureau, the federal public policy arm of our nation's oldest, largest and best-known grassroots civil rights organizations.

I would like to begin by thanking our good friend Senator Dodd and the other members of this committee for holding this hearing. By making predatory lending the subject of one of the very first hearings held by this committee in the 110th Congress, you are giving it the attention it deserves. We look forward to working diligently with you on this issue over the course of the next few years.

I am here today because predatory lending is unequivocally a major civil rights issue.

As study after study has conclusively shown, predatory lenders target African Americans, Latinos, Asians and Pacific Islanders, Native Americans the elderly and women at such a disproportionate rate that the effect is devastating to not only individuals and families, but whole communities as well. Predatory lending stymies families' attempts at wealth building, ruins people's lives and, given the disproportionate number of minority homeowners who are targeted by predatory lenders, decimates whole communities.

High concentrations of subprime lending in predominantly racial and ethnic minority neighborhoods and racial disparities in subprime lending exist in all regions of the nation. And, while not all subprime loans are predatory (indeed the NAACP recognizes the benefits of the subprime market to a constituency which includes many without a strong traditional credit history), it is estimated that the vast majority of predatory loans, or those with onerous fees and / or conditions, exist in the subprime market.

A study put out late last year by the Center for Responsible Lending demonstrated that for most types of subprime home loans, African American and Latino borrowers are more than 30% more likely to have higher rate loans than Caucasian borrowers, even after accounting for differences in risk[1]. Moreover, a study released just last month showed that high-income African American and Latino borrowers in the Boston are were six to seven times more likely to have an expensive mortgage than Caucasians in the same income bracket in 2005[2]. Given that few would argue that Boston is, most likely, indicative of the rest of the nation, this study clearly refutes arguments that subprime lending and predatory features are introduced solely across economic lines to mitigate risk.

It is important to recognize that almost seven years ago a study by the U.S. Department of Housing and Urban Development clearly demonstrated that many people of color could qualify for more affordable loans than they were receiving which in turn would enable them to maintain and build additional wealth. In 1996, a study by Fannie Mae and Freddie Mac reported that as many as a third of the families who receive subprime loans actually qualify for prime loans[3]. Unfortunately, prime lending institutions continue to under serve people of color and whole communities occupied predominantly by racial or ethnic minorities.

Perhaps even more problematic is that despite the fact that blatant racial bias, and its debilitating effects, have been clearly demonstrated and well documented, little has been done; the disparities continue.

In fact, according to the most recent data available, in 2005 African Americans were 3.2 times more likely to receive a higher cost, subprime loan than their Caucasian counterparts; Latinos were 2.7 times more likely to receive a higher rate loan than white borrowers[4].

The bottom line is that predatory lending is making homeownership more costly for African Americans and other racial and ethnic minorities, as well as women and seniors than for whites and middle class families.

Given that homeownership is one of the most reliable ways for economically disadvantaged populations to close the wealth gap, one direct result of this unfair and immoral discriminatory practice is that it is harder for African Americans and other racial and ethnic minorities to build wealth or pass any material possessions on to their heirs.

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[1] Center for Responsible Lending. May 31, 2006. "*Unfair Lending: The effect of Race and Ethnicity on the Price of Subprime Mortgages*" Debbie Gruenstein Bocian, Keith Ernst and Wei Li.
[2] Massachusetts Community and Banking Council. January 2007. "*Borrowing Trouble VII: Higher Cost Mortgage-Lending in Boston, Greater Boston, and Massachusetts in 2005*" Jim Campben
[3] Freddie Mac. September 1996. *Automated Underwriting: Making Mortgages Lending Simpler and Fairer for America's Families. Washington DC*
[4] Robert B. Avery, Kenneth P. Brevoort and Glen B. Canner, "*Higher Priced Home Lending and the 2005 HMDA Data*," Federal Reserve Bulletin, amended September 18, 2006.

Predatory lending is a direct attack on our financial security and economic future; an attack that is targeted at individuals and communities because of the color of our skin.

I would like to take a moment to discuss with the committee one type of predatory loans that has become increasingly worrisome as of late.

Specifically, over 80% of home loans made in the subprime market today are adjustable rate mortgage (ARMs) loans and the so-called "2/28" or "3/27" mortgages are the dominant product.

This is important since over half of the loans made to African Americans in 2005 and four out of ten made to Latino homeowners were subprime loans[5]. Geographic concentrations of 2/28s in certain neighborhoods and communities of color have led to spikes in foreclosures and attendant community disinvestment.

Unlike most ARMs in the prime market, the short-term fixed rate on 2/28s and other, similar loans is typically artificially low. When the loan adjusts after the initial two year period subprime borrowers face enormous "payment shock", with mortgage payment increases in a typical 2/28 loan of up to or over 50% monthly.

Combined with other features typical of 2/28s, such as prepayment penalties[6] and the lack of escrows, 2/28s have the very real potential to place homebuyers in financial crisis.

Over the next two years, an estimated $600 billion in subprime mortgages will reset from the two-year teaser rates and many borrowers, including an overrepresentation of African Americans and Latinos, will face a significant increase in their monthly payments[7].

The impact this will have on whole neighborhoods and communities predominantly populated by African Americans, Latinos and other racial and ethnic minority Americans will be nothing short of devastating. A report issued last year by the Center for Responsible Lending estimated that 1 out of every 5 mortgages that originated during the last two years will end in foreclosure[8].

To date, the federal government has be largely inattentive to the problems surrounding predatory lending, and in fact some of the rules and proposals we

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[5] Federal Financial Institutions Examination Council (FFIEC), Home Mortgage Disclosure Act data for 2005

[6] According to the Center for Responsible Lending, 70% of subprime mortgages feature prepayment penalties. For a family with a $150,000 mortgage at an interest rate of 10%, a typical prepayment penalty imposes a fee of $6,000 for an early payoff (which includes refinancing). This amount is more than the entire net worth of the median African American family.

[7] Jonathan R. Liang, *Coming Home to Roost*, BARRONS (New York, NY), February 13, 2006

[8] Center for Responsible Lending. December, 2006. "*Losing Ground: Foreclosures in the Subprime Market and their Cost to Homeowners*" Ellen Schloemer, Wei Li, Keith Ernst and Kathleen Keest.

have seen in the last few years appear to go backward and take away some of the few protections we have gotten at the state level.

This flies in the face of the NAACP's belief that the primary responsibility of the government is to protect its citizens, all of its citizens, not to exploit them for the gain of a few.

As our elected representatives the NAACP calls on Congress to enact an aggressive and effective federal law, and to soundly reject attempts at addressing predatory lending that will not resolve the underlying problems and will, in fact, roll back the few protections that a few states have put into place.

Because I was asked to speak to you today on behalf of the national civil rights community, I would like permission to include in the record three documents which are attached to my written testimony. The first two were both prepared by the fair housing subcommittee of the Leadership Conference on Civil Rights (LCCR), of which the NAACP is a proud and active member. The first article outlines our position on federal predatory lending legislation and outlines some elements that we consider to be essential in any effective proposal. The second paper expands on our concerns about 2/28 and other exploding ARMS.

The last attachment is a letter that was sent just this morning to Chairman Dodd and Ranking Member Shelby, as well as the Chairman and Ranking Member of the House Banking Committee. This letter was signed by approximately 200 national and state civil rights, consumer, and housing rights groups including the NAACP and it lays our some of our primary goals in any anti-predatory lending legislation this year.

Thank you again, Chairman Dodd and members of this committee for holding this hearing and for taking the time today to take a serious look at the very real problems associated with predatory lending. As I mentioned earlier, the NAACP stands ready to work with you on aggressive, comprehensive legislation to address this very real civil rights scourge.

LCCR POSITION PAPER ON PREDATORY LENDING LEGISLATION

October 2006

THREATS TO THE HOMEOWNERSHIP AND FINANCIAL SECURITY OF DIVERSE POPULATIONS

Today, too many individuals and families are targeted for abusive home loans that strip away their hard-earned home equity and put their homes at a high risk of foreclosure. People of color are at greater risk of losing hard-earned wealth—and even their homes—as a result of high-cost, risky lending and abusive servicing. These predatory practices also disproportionately impact the disabled, seniors and female headed-households.

Many people of color could qualify for more affordable and fair loans that would enable them to maintain and build additional wealth. Unfortunately, many prime lending institutions continue to underserve people of color. Although some in the subprime lending industry have claimed that factors such as income and credit histories account for racial disparities, credible reports and studies which control for these factors refute these claims. As early as 2000, HUD found that African-American families living in upper-income neighborhoods were more likely to receive subprime loans than white families living in low-income neighborhoods.[i] Fannie Mae and Freddie Mac report that as many as a third of the families who receive subprime loans actually qualify for prime loans.[ii] Two reports issued in May this year have shown that African-American and Latino individuals and families are much more likely to receive high interest rate loans than white individuals and families, even with the same credit profile.[iii]

While clearly not all subprime lending is predatory, a significant share of predatory lending takes place in the subprime market. Although there are predatory lenders in the prime market as well, predatory lending in the subprime market is particularly destructive to minority and other vulnerable communities. Subprime loans not only cost more over time, but can strip away wealth that has already been earned. Large fees and prepayment penalties, which are rare in the prime mortgage market, are much more common on subprime loans. Many subprime homeowners are put into loans they cannot possibly afford to repay by lenders and mortgage brokers.[iv] This happens in part because both have strong market incentives to push such loans. For example, mortgage brokers receive large bonuses—called yield spread premiums—for putting families in loans with higher interest rates when they qualify for lower-cost loans.

All of these onerous terms and abusive practices dramatically increase the risk of foreclosure. According to a study by the University of North Carolina, one in five families that received a subprime refinance home loan in 1999 had entered foreclosure at least once by 2004. In jurisdictions where lenders are permitted to begin foreclose without judicial review (roughly half the states[v]) borrowers have little to no recourse to protect themselves other than to delay the foreclosure process by declaring bankruptcy.

Essential Elements of Predatory Lending Legislation

Any predatory lending law should include these essential provisions:

Effective rights and remedies: These include: (1) the availability of a private right of action and class actions, which are often the only effective way to gain appropriate remedies to these abusive practices and deter bad actors; (2) strong remedies and penalties for abusive acts; (3) effective assignee liability so that borrowers can bring their claims against those who buy, service, securitize or collect (including foreclose) on their loans; and (4) prohibitions on mandatory arbitration clauses that weaken victims' legal rights and prevent them from bringing claims to a court of law. Without these fundamental procedural protections, any substantive consumer protection rules are unenforceable. There needs to be greater accountability for all players in the mortgage industry.

Prohibitions against steering: Steering borrowers to loans with interest rates far higher than they qualify for is very costly for people of color, and must be prohibited for all home loans.

A suitability standard: Many borrowers are being placed in loans they cannot possibly afford to repay. Lenders and mortgage brokers should ensure that a loan is suitable for the borrower's objectives and circumstances.[vi]

"High-cost" must include all loan fees: Predatory lending laws typically define high-cost loans and provide protections for those loans that are the most likely to be subject to abuse. To provide effective protections for these loans, the definition of a high-cost loan must include all of the different loan fees that lenders and brokers charge, including prepayment penalties and yield spread premiums.

No federal preemption: The majority of states have passed laws to address predatory lending. Many of these laws have been highly effective in reducing abusive lending without impeding access to credit. In order to protect states from increasing claims of preemption, any federal law must permit states to enforce their own laws. State protections have a proven track record, such as requiring counseling before borrowers are sold a high-cost loan and curbing prepayment penalties on subprime loans. Historically, federal laws have set floors for protections, and states have been able to build on these federal protections.[vii] In this area of mortgage lending it is especially important that state authority be preserved, as abusive lenders rapidly develop new abusive tactics that will not be addressed by any federal law.

Advance disclosure of costs and fees: Too often borrowers discover at the closing table that the terms and conditions of their loan have changed. At this point, it is often difficult for the borrower to negotiate a return to the original deal or to postpone the closing to allow for further discussions with the lender. All lenders should be required to provide at least seven (7) days prior to closing, the final terms, conditions and costs of the loan to the borrower. This disclosure should also include any costs and fees associated with servicing.

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[i] For example, one study by HUD in 2000 found that as much as one-half of refinance loans made in predominately black neighborhoods are subprime. U.S. Department of Housing and Urban Development and U.S. Treasury Department. 2000. *Curbing Predatory Home Mortgage Lending.* Washington, DC: U.S. Department of Housing and Urban Development.

[ii] See, e.g. Freddie Mac. Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families. Washington, D.C. September 1996. See also Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols, Credit Risk and Mortgage Lending: Who Uses Subprime and Why? Washington, D.C.: Research Institute for Housing America, Working Paper 00-03 (finding that probability of African American borrower receiving subprime loan increased by 1/3 compared with white borrower, controlling for risk).

[iii] Debbie G. 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); Allen J. Fishbein, Patrick Woodall, *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders*, Consumer Federation of America (May 2006)

[iv]The most common subprime loan, known as a "2/28," has a low rate for the first two years and then monthly payments increase by 40-50%, even if market interest rates do not go up. Most families cannot absorb this large payment shock, and their homes are put at risk of loss.

[v] NCLC Repossessions and Foreclosures Manual, Appendix (5th ed. 2002 and Supp. 2004).

[vi] Many professions require practitioners to serve their clients best interests. For example, investment advisors are required to sell only suitable products to their clients. Similarly, state-licensed real estate agents work explicitly for the seller or buyer.

[vii] For example, the Fair Housing Act states that "nothing in the Act will be construed to invalidate or limit any law of a State or political subdivision of a State." 42 U.S.C. § 3615.

2/28s and Other Exploding ARMS

What are 2/28s?

Over 80 percent of home loans made in the subprime market today are adjustable rate mortgage (ARM) loans and 2/28's are the dominant product. The 2/28 stands in contrast to the well-known 30-year fixed rate mortgage. Instead, a 2/28 mortgage product features an initial short-term fixed rate for two years, followed by rate adjustments, generally in six-month increments for the remaining 28 years of the loan.[vii]

Unlike most ARMs in the prime market, the short-term fixed rate on the subprime loan is typically artificially low. When the loan adjusts after the initial two year period, in the case of the 2/28, subprime borrowers face enormous "payment shock," with mortgage payment increases of up to and over 50% monthly. Most subprime lenders qualify borrowers for ARMS at or near the introductory interest or teaser rate, rather than to the "fully indexed rate" that will apply once the rate resets. The fully indexed rate is determined by adding a fixed amount, or "margin," to a market index such as LIBOR (London Interbank Offered Rate). Because the margin is so large, borrowers with subprime 2/28s face a payment increase of up to 50 percent within a few months after the initial adjustment, even if interest rates do not rise. Combined with other features typical of 2/28s, such as prepayment penalties[vii] and the lack of escrows, 2/28s could place subprime borrowers in extreme financial crisis. These characteristics mean that 2/28s are essentially the equivalent of balloon mortgages, and have led some to describe them as "exploding" mortgages.

2/28s and Other Exploding Mortgages Are Hurting Communities of Color

These loans destroy families and communities of color by stripping them of vital home equity. Geographic concentrations of 2/28s in certain neighborhoods and communities of color have led to spikes in foreclosures and attendant community disinvestment. According to the most recent HMDA data issued by the FRB, over half of loans to African-American borrowers and four in ten loans to Latino borrowers were subprime loans.[vii] The overwhelming majority of subprime loans—over two-thirds-- are 2/28s or 3/27s. Therefore a high percentage of African-American and Latino homeowners who received subprime loans have 2/28 or 3/27 mortgages.

These mortgage products often lack escrows and include harsh "prepayment penalties."[vii] These penalties box borrowers into high-rate loans, even if the borrower had good credit at origination or after the borrower has bettered her/his credit and wishes to refinance. For example, for a family with a $150,000 mortgage at an interest rate of 10 percent, a typical prepayment penalty imposes a fee of $6,000 for an early payoff – an amount *greater than the entire net worth of the median African-American family.*[vii] Moreover, according to an analysis by the Center for Responsible Lending, borrowers residing in zip codes whose population is at least 50 percent minority are 35 percent more likely to receive loans with prepayment penalties than financially similar borrowers in zip codes where minorities make up less than 10 percent of the population.[vii]

Over the next two years, an estimated $600 billion in subprime mortgages will reset from the two-year teaser rates and many borrowers, including an overrepresentation of African-Americans and Latinos, will face a significant increase in their monthly payments.[vii] Opportunities to refinance will become much more limited as interest rates rise and housing appreciation continues to slow. Opportunities to get out of these detrimental loans are also limited by the prevalence of prepayment penalties that deter borrowers from refinancing.

Instead, many of these loans will lead to devastating foreclosures. In a recent report, the Center for Responsible Lending estimated that nearly one out of five (19 percent) subprime mortgages originated during the past two years will end in foreclosure. The report observed a higher risk of foreclosure for adjustable-rate mortgages (ARMs) compared with fixed-rate mortgages, finding that the foreclosure risk for ARMs was 62 percent to 123 percent higher, depending upon the year the loan was originated.[vii]

Agencies and CSBS Should Clarify that Their Guidance Covers Exploding ARM Mortgages

On September 29, 2006, U.S. banking regulators[vii] issued interagency guidance on non-traditional mortgage product risks that require lending institutions to improve underwriting standards for interest-only and payment option ARMs by taking into consideration a borrower's ability to repay loans once introductory rates and terms no longer apply.[vii]

The agencies should clarify that 2/28, 3/27 and other exploding ARM loans are covered by the recent interagency guidance. In addition, because the interagency guidance does not apply to most subprime lenders because they are not regulated by these federal agencies, the CSBS should also clarify its guidance. The Center for Responsible Lending estimates that the lenders who are not subject to safety and soundness oversight by the federal agencies (and therefore are not subject to the recent guidance) made 58% of all first-lien subprime home loans in 2005.[vii]

Federal Reserve Should Exercise Its Discretionary Authority under HOEPA

The Federal Reserve should also exercise its discretion as the agency with rule-making authority under the Home Ownership and Equity Protection Act (HOEPA) to limit the use of subprime exploding ARM mortgages.[vii] HOEPA provides broad authority to prohibit unfair or deceptive mortgage lending practices and to address abusive refinancing practices on all mortgage loans, not only high-cost loans. However, the Federal Reserve has never exercised this authority. By issuing a regulation under HOEPA, the Federal Reserve would ensure that all subprime mortgage loans in the country were subject to the same rules.

February 5, 2007

The Honorable Barney Frank
Chairman
House Financial Services Committee

The Honorable Spencer Bachus
Ranking Member
House Financial Services Committee

The Honorable Chris Dodd
Chairman
Senate Banking Committee

The Honorable Richard Shelby
Ranking Member
Senate Banking Committee

Dear Chairman Dodd, Chairman Frank, Ranking Member Bachus and Ranking Member Shelby:

Homeownership is the most accessible tool available to help families achieve a secure economic future, but today market failures and abusive lending practices are stripping the benefits of homeownership from millions of families **throughout the mortgage market.** The epidemic of home losses on subprime mortgages—as many as one in five— is a wake-up call, providing strong evidence that the current system of mortgage regulation is seriously flawed. To preserve homeownership for American families, we need real, systemic change embodied in policies that protect the **sustainability of homeownership**. Below, we outline a policy framework that would drive effective solutions to preserve the traditional benefits of owning a home. Our views represent those of many consumer, civil rights, and community groups, as well as a number of responsible mortgage lenders.

As Congress begins a new session, we respectfully ask that any new anti-predatory lending legislation be based on the following principles:

- **Restore sensible underwriting and eliminate unsustainable loans;**
- **Eliminate incentives for lenders to steer borrowers to abusive loans;**
- **Require accurate and accountable loan servicing;**
- **Ensure effective rights and remedies for families caught in predatory loans;**
- **Preserve essential federal and state consumer safeguards; and**
- **Reduce foreclosures through assistance to distressed borrowers.**

Sustainable loans. Many lenders have abandoned careful lending standards to make loans that borrowers cannot repay without refinancing or selling their home. As a result of this weak underwriting, an increasing number of homeowners are unable to keep up with their mortgage payments. High-risk adjustable rate (ARMs) mortgages, which are underwritten to a low teaser payment instead of to the fully indexed rate, are an example of this problem. Studies show that today's subprime mortgages typically include features that increase the chance of foreclosure *regardless of the borrower's credit.* This has caused many families to default on unnecessarily risky loans and lose their homes. Other families are forced to refinance and pay associated fees or sell their home. *Responsible lending demands a realistic analysis of the borrower's ability to repay the loan based on all its terms.*

Incentives for fair loans. The subprime market now rewards lenders and brokers who charge borrowers excessive points and fees or channel them toward riskier loan products. Unknown to most borrowers, brokers receive payments known as "yield spread premiums" for selling loans at a higher interest rate than the lender requires. Most subprime mortgages also include prepayment penalties, which can cost families thousands of dollars when they refinance or pay off their loans early. Too often the borrower does not receive a lower interest rate in exchange for the prepayment penalty. In the inefficient subprime market, prepayment penalties are simply another method of stripping home equity or trapping borrowers in costly loans. These fees are only appropriate when they are in exchange for a real benefit to the borrower. A law to sustain homeownership must prohibit brokers and lenders from steering borrowers into mortgages with excessive costs.

Accountable loan servicing. Companies that collect payments on mortgages—loan servicers—have tremendous influence on the success of the loan. Servicer errors and unfair practices in recent years have contributed to the recent surge in foreclosures. Problems typically arise when loan servicers impose costly and unnecessary hazard insurance or delay crediting mortgage payments so that they can charge costly late fees to the homeowner. As it stands now, mortgage servicers have incentives to profit from loan defaults. In a healthy and truly competitive market, loan servicers would charge reasonable fees and support homeowners' efforts to avoid foreclosure.

Basic rights and remedies. Victims of abusive lending practices have very little recourse because industry often uses its market power to limit homeowners' access to justice. To be effective, consumer protection laws must: (1) give families a private right of action, the right to pursue class actions, and defenses against collection and foreclosure, which are often the only effective way to deter bad actors; (2) contain strong remedies and penalties for abusive acts; (3) provide effective assignee liability so that borrowers can pursue legitimate claims even when the originator has sold their loan; and (4) prohibit mandatory arbitration clauses that weaken victims' legal rights and deny them access to seeking justice in a court of law. Without these fundamental procedural protections, other consumer protection rules are unenforceable.

Preserve and advance existing protections. Current laws contain certain essential consumer protections designed to address some of the egregious practices in the mortgage industry, and these protections must be preserved. In particular, the majority of states have passed laws that have been highly effective in curbing abusive lending practices without hampering borrowers' access to credit. Any new law must build on these protections, bearing in mind that real estate markets vary significantly in different locations, and that states are in the strongest position to address new lending abuses that evolve over time. Legislative solutions must also preserve protections for families outside the mainstream real estate market—for example, those who use alternative ownership options such as mobile and manufactured housing and seller-driven financing; are credit impaired; have limited or no credit histories; have limited English skills; or are located in high-poverty areas.

Reduce skyrocketing foreclosures. Any new law should preserve the benefits of homeownership by assisting homeowners already in distress. Recent research shows that as many as one out of five subprime mortgages made in recent years will end in foreclosure. In addition to strengthening the market to benefit future borrowers, legislation should address the increasing numbers of existing homeowners who risk losing their home. Federal legislation could build on successful state models to provide affordable homeownership preservation loans to borrowers who are in default due to circumstances beyond their control.

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We welcome legislation that, based on the principles outlined above, contains effective solutions to current problems and allows rapid responses to emerging abuses. We look forward to working with you on the critical issue of preserving the benefits of homeownership, and we thank you for your time and consideration.

Sincerely,

AARP
AFL-CIO
American Council on Consumer Awareness
Association of Community Organizations for Reform Now (ACORN)
Center For Responsible Lending
Coalition of Community Development Financial Institutions
Consumer Action
Consumer Federation of America
Consumer's Union
International Union, United Auto Workers.
Leadership Conference on Civil Rights
NAACP (National Association For The Advancement of Colored People)
NAACP Legal Defense & Educational Fund, Inc.
National Association of Consumer Advocates
National Consumer Law Center (on behalf of it's low-income clients)
National Council of La Raza

National Fair Housing Alliance
National Lawyers' Committee for Civil Rights Under Law
National People's Action
National Training and Information Center
Rainbow/ Push
U.S. Public Interest Research Group
Affordable Housing Education and Development, Inc. (NH)
Alaska Public Interest Research Group
Alexandria Affordable Housing Corporation (LA)
Allen Neighborhood Center (MI)
American Community Partnerships (DC)
American Friends Service Committee NH Program, (NH)
Arizona Consumers Council
Arizona PIRG
Birmingham Business Resource Center, (AL)
Border Fair Housing & Economic Justice Center (TX)
Cabrillo Economic Development Corp. (CA)
California Reinvestment Coalition
Cambridge Consumers' Council
CATCH Neighborhood Housing (NH)
Ceiba Housing and Economic Development Corp. (Puerto Rico)
Center for Consumer Affairs (WI)
Center for Social Concerns, University of Notre Dame
Champaign County Health Care Consumers (IL)
Cherokee Nation (OK)
Chicago Consumer Coalition
Cincinnati Change (OH)
Civil Justice, Inc
Coastal Enterprises, Inc. (ME)
Codman Square Neighborhood Development Corp. (MA)
Colorado Rural Housing Development Corporation (CA)
Columbia Consumer Education Council (SC)
Community Development Corporation of Long Island, Inc. (NY)
Community Enterprise Investments, Inc. (FL)
Community Frameworks (WA)
Community Housing Development Corporation of North Richmond
Community Housing Partners Corporation (VA)
Community Law Center
Community Law Center, Inc. (MD)
Community Neighborhood Housing Services, Inc. (MN)
Community Reinvestment Association of North Carolina (NC)
Consumer Federation of California
Consumer Federation of Southeast
Corporation for Enterprise Development (DC)
Cuyahoga County Foreclosure Prevention Program

Dayton Community Reinvestment Coalition (OH)
Delaware Community Reinvestment Action Council, Inc. (DE)
Department of Sociology and Anthropology, IU South Bend
Detroit Alliance for Fair Banking (MI)
Durham Community Land Trustees (NC)
East Akron Neighborhood Development Corporation Inc. (OH)
Empire Justice Center
Enterprise Corporation of the Delta/HOPE (MS)
Fair Housing Council of the San Fernando ValleyHousing Research & Advocacy Center (out of Cleveland)
Fort Berthold Housing Authority (ND)
Foundation Communities (TX)
Frontier Housing, Inc. (KY)
Greater Rochester Community Reinvestment Coalition (NY)
Hamilton County Community Reinvestment Group (OH)
Hawaiian Community Assets (HI)
HEED (MS)
Home Management Resources
Homeward, Inc. (IA)
Housing and Credit Counseling, Inc.(KS)
Housing Assistance Program of Essex County, Inc. (NY)
Housing Education Program (CA)
Housing Opportunities Made Equal of Virginia, Inc.
Housing Partnership of Northeast Florida, Inc. (FL)
Indiana Association for Community Economic Development (IN)
Inglewood Neighborhood Housing Services, Inc. (CA)
Jacksonville Area Legal Aid, Inc.
Jewish Community Action, (MN)
Joseph Corporation of Illinois, Inc. (IL)
Justine Petersen Housing & Reinvestment Corporation (MO)
Kensington-Bailey Neighborhood Housing Services, Inc. (NY)
Knox Housing Partnership, Inc. (TN)
LaCasa of Goshen, Inc. (IN)
Latino Leadership, Inc. (FL)
Lawyers' Committee For Civil Rights Under Law of the Boston Bar Association (MA)
Long Island Housing Services, Inc. (NY)
Louisiana CRA Coalition (LA)
Madison Park Development Corporation (MA)
Manna, Inc. (DC)
Mass Consumers' Coalition
MassPIRG
Metropolitan Housing Coalition (KY)
Metropolitan Milwaukee Fair Housing Council (WI)
Metropolitan St. Louis Equal Housing Opportunity Council (MO)
Miami-Dade Neighborhood Housing Services, Inc. (FL)

Michigan Community Reinvestment Coalition, (MI)
Micronesia self-Help Housing Corporation
Mission Economic Development Agency (MEDA
Monmouth County Fair Housing Board, (NJ)
Montgomery Housing Partnership (MD)
Mountain State Justice, Charleston, W.V.
National Association of Community Economic Development Associations (MD)
National Community Reinvestment Coalition
National NeighborWorks Association (DC)
Native American Health Coalition (TX)
Navajo Housing Authority (AZ)
Nehemiah Community Reinvestment Fund, Inc. (CA)
Neighborhood Housing Partnership of Greater Springfield, Inc. (OH)
Neighborhood Housing Services of Baltimore, Inc. (MD)
Neighborhood Housing Services of Greater Cleveland, Inc. (OH)
Neighborhood Housing Services of Kansas City, Inc. (MO)
Neighborhood Housing Services of New Haven, Inc. (CT)
Neighborhood Housing Services of Oklahoma City, Inc. (OK)
Neighborhood Housing Services of the Black Hills, Inc. (SD)
Neighborhood Housing Services of the Lehigh Valley, Inc. (PA)
Neighborhood Housing Services, Inc. (PA)
Neighborhood Nonprofit Housing Corporation
Neighborhood Renewal Services of Saginaw, Inc. (MI)
NeighborWorks Columbus (GA)
NeighborWorks Rochester (NY)
New Directions Housing Corporation (KY)
New Jersey Citizen Action, (NJ)
NHS of Chicago (IL)
Northeast South Dakota Community Action Program
Northeast South Dakota Economic Corporation
Northwest Indiana Community Reinvestment Alliance (IN)
Norwalk (Connecticut) Fair Housing (CT)
Notre Dame Legal Aid
Nuestra Comunidad Development Corp. (MA)
Opportunity Finance Network
Oregon Consumer League
Piedmont Housing Alliance
Pittsburgh Community Reinvestment Group (PA)
PPEP MicroBusiness and Housing Development Corporation
PPEP Microbusiness and Housing Development Corporation, Inc. (AZ)
Project Change Fair Lending Center (NM)
Reservoir Hill Improvement Council
Rural Opportunities, Inc. (NY)
Salisbury Neighborhood Housing Services, Inc. (MD)
Sargent Shriver National Center on Poverty Law (IL)

Scott County Housing Council (IO)
Scranton Neighborhood Housing Services, Inc. (PA)
Seedco
Self-Help Enterprises (CA)
Shorebank
Shorebank Enterprise Pacific
Siouxland Economic Development Cooperation
SJF Ventures
South Bend Center for the Homeless
Southeast Community Development Corporation
Southern Good Faith Fund (AR)
Southwest Fair Housing Council (AZ)
St. Joseph Valley Project
Tlingit-Haida Regional Housing Authority (AK)
Tri-County Housing & Community Development Corporation (CO)
Unidos Para La Gente (TX)
United Keetoowah Band of Cherokee Indians (OK)
United Neighborhood Centers of Northeastern Pennsylvania (PA)
United South Broadway Corporation (NM)
Utica Neighborhood Housing Services, Inc. (NY)
Village Capital Corporation
Virginia Citizens Consumer Council
Virginia Poverty Law Center
West Elmwood Housing Development Corp. (RI)
Westchester Residential Opportunities, Inc. (NY)
Western Massachusetts Enterprise Fund
Wisconsin Consumers League
Working Together for Jobs, (NJ)

MORTGAGE BANKERS ASSOCIATION
Investing in communities

Statement of

Douglas G. Duncan, PhD

Senior Vice President of Research and Business Development, and Chief Economist

Mortgage Bankers Association

Washington, DC

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

Hearing on

"Preserving the American Dream: Predatory Lending Practices and Home Foreclosures"

February 7, 2007

Chairman Dodd, Ranking Member Shelby and Members of the Committee, my name is Doug Duncan and I am the Mortgage Bankers Association's (MBA's) Chief Economist and Senior Vice President of Research and Business Development.[1] Thank you for the opportunity to testify before you today as your review and consider the issues of predatory lending and foreclosures.

Before I begin, let me say, that we all share the same commitment – to come up with solutions to better protect consumers from abusive lending. When abusive lending happens, it is a stain on the mortgage industry just as it is a burden on our families and communities. The real estate finance industry has provided homeownership opportunities across this nation and has been a driving force in establishing communities, creating financial stability and wealth for consumers and fueling the overall economy. Our industry has helped our country reach a near 70 percent homeownership rate – to the benefit of us all – and MBA is committed to finding solutions to help weed out bad actors and, where appropriate, bring them to justice.

MBA believes there are three things the government can do to help to protect consumers. First, make financial education a priority in this nation, empowering consumers with knowledge and giving them the tools they need to make good decisions and protect themselves. Second, is to simplify and make more transparent the mortgage process so that consumers may better understand the details of the transaction and facilitate shopping more efficiently from lender to lender. Third, is to enact a strong and balanced uniform national standard for mortgage lending with increased consumer protections.

The mortgage industry has been extremely innovative in developing products and financing tools that create homeownership opportunities, expand affordability and facilitate greater consumer choice. Recently, however, there have been claims that these very products and financing tools are themselves in some way bad for consumers and have driven foreclosure rates to a state of crisis. Some advocacy organizations seek new, rigid underwriting standards and the imposition of "suitability" requirements. MBA is concerned that these approaches, which might look reasonable at first, will simply stifle innovation and take good financing options out of the hands of homeowners limiting consumer choice. The effect will be to undermine our mutual goal of putting Americans in homes and keeping them there.

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the Nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field.

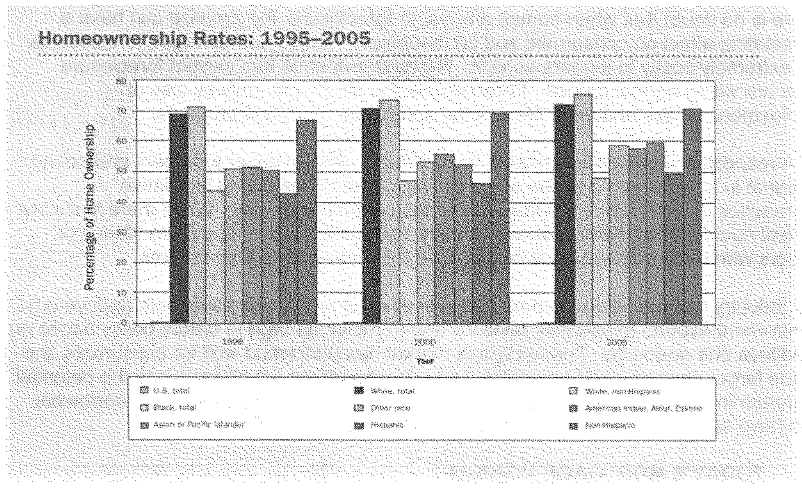
There is no doubt that when homes are lost to foreclosure, the process can have a devastating affect on consumers and communities. Please do not forget, foreclosures are extremely costly to lenders as well. We have evidence that current foreclosure rates are within normal ranges. Foreclosures are driven primarily by loss of employment, illness and other life events, and not by mortgage products.

MBA respectfully asks policy makers to continue to rely on sober judgment and sound research in assessing the scope of the problem when considering legislative approaches that will affect this key area of the nation's economy. While there likely are a small number of bad actors in our industry, there are many, many more stories of lenders who have helped borrowers achieve their homeownership dreams.

Our industry has considerable data that we will continue to make available and we urge government experts to carefully review it and to resist the urge to create policy based on headlines and anecdote. The mortgage market has performed well for consumers and for the larger economy and any policy that is not based on sound facts has the potential to undermine these benefits – particularly for those previously underserved borrowers who have so greatly benefited from recent innovations.

I. TODAY'S MORTGAGE MARKET

Homeownership is near its highest level in history – nearly 70 percent overall. Homeownership rates rose roughly 3.5 percentage points in the U.S. between 1989 and 2001. Looking at recent years, in 2001, the overall homeownership rate was 67.8 percent. In 2006, it was 68.9 percent. For African-Americans, the rate in 2001 was 47.7 percent, and in 2006 it grew to 48.2 percent (although it was 49.1 percent in 2004). For Hispanics, the rate in 2001 was 47.3 percent and in 2006 it was 49.5 percent.



As a result of these increases in homeownership, across all demographics, Americans are building tremendous wealth by increasing their home equity through their monthly payments and through the impressive rate of home price appreciation seen in recent years. According to the Federal Reserve Board's (FRB) Flow of Funds data, the value of residential real estate assets owned by households has increased from $10.3 trillion in 1999 to $22.4 trillion as of the first quarter of 2006, and aggregate homeowners' equity now exceeds $10 trillion. According to the FRB's 2004 Survey of Consumer Finances, the median net worth for homeowners was $184,000. For renters, it was $4,000.

More than a third of all homeowners own their home free and clear of any lien. Of the remaining two-thirds of homeowners who do have mortgages, three-quarters have fixed rate mortgages. Only one quarter of these borrowers, or about a sixth of all homeowners, have adjustable rate mortgages (ARMs).

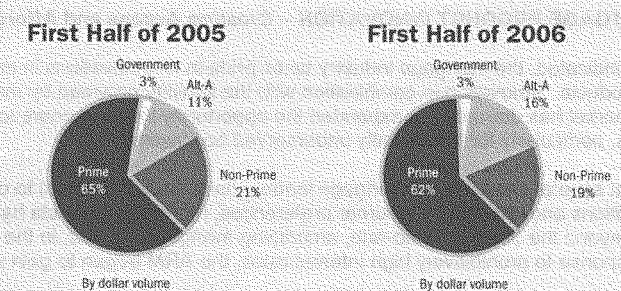
Homeowning Household Distribution
By Mortgage Type

Household Mortgage Type	Percent	Percent of Those with a Mortgage
No Mortgage	**34.6**	
Fixed Rate	49.2	75.2
Adjustable Rate	**16.2**	**24.8**
Jumbo	3.9	6.0
Conforming	12.3	18.8
Total	**100.0**	**100.0**

Source: American Housing Survey; Mortgage Bankers Association

According to MBA's Mortgage Originations Survey, in the first half of 2006, 62 percent of the dollar volumes of loans originated were prime loans, 16 percent were Alt. A, and 19 percent were non-prime, with government loans accounting for the remaining 3 percent.

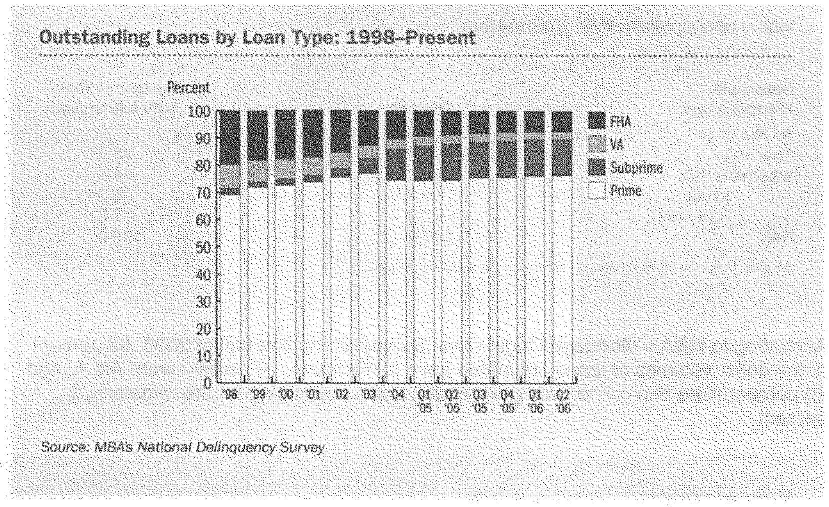
Mortgage Originations by Loan Type



Source: MBA's Mortgage Origination Survey

Estimates from MBA's National Delinquency Survey indicate that the number of nonprime loans has increased more than 6.5 times over the last five years (Q3 2001 to Q3 2006).

Based on first half 2006 data, nearly half of non-prime borrowers, or 45 percent, utilize nonprime loans to buy homes. One in four of these purchases was by a first-time homebuyer. Also, notably, over the last several years the average difference between the interest rates of prime loans and non-prime loans has decreased markedly.



II. MORTGAGE PRODUCT INNOVATION – Creating Access and Affordability

As we have indicated, the mortgage industry takes pride in its innovations in developing mortgage products. Innovation in combination with the liquidity provided by the secondary market has dramatically expanded the opportunity for consumers to become homeowners, particularly for traditionally underserved borrowers.

Over the past several decades, as mortgage lenders have sought to adapt to changing market conditions and changing consumer preferences, mortgage products have developed beyond the 30-year, fixed-rate, amortizing mortgage. In fact, in the early 1980s, in response to prohibitively high interest rates, the ARM began to gain wide acceptance.

In addition to ARMs, some lenders at the forefront of responding to consumer demand for product diversity, particularly in high cost markets, began to offer interest-only and payment-option mortgages. Mortgage lenders have successfully offered such products for decades, through different market cycles, without a threat to their safety and soundness. It is therefore prudent to look to the practices of lenders regarding nontraditional mortgage products but not to impose prescriptive requirements that would force them to change proven standards, disadvantaging institutions from effectively participating in this market.

Over the last decade, hybrid ARMs, where the initial interest rate is fixed for a period of time and then adjusts annually, also have gained wide acceptance. Borrowers now can take advantage of hundreds of different financing options based on their individual needs and circumstances. They can also choose among thousands of mortgage originators. MBA supports the opportunity for consumers to make their own choices. They are in the best position to choose which mortgage option is best for them and their families.

A. Nontraditional Mortgage Products

"Nontraditional mortgage products" refer to financing options which have been developed to increase flexibility and affordability and otherwise meet the needs of homebuyers who have been purchasing homes in an environment where real estate prices have increased faster than borrowers' incomes. Other homeowners have used these products to tap their homes' increased equity for a variety of needs including home improvements and renovations, paying down other forms of debt, as well as education and healthcare needs. While these products have often been characterized as "new," some of them actually predate long term fixed-rate mortgages. Nontraditional mortgage products include fixed- and adjustable-rate loans that permit interest only (IO) payments and payment-option loans including option ARMs.

MBA strongly believes that the market's success in making these "nontraditional" products available is a positive development. Although these products have been used to finance a relatively small portion of the nation's housing, they have offered and continue to offer new, useful choices for borrowers.

Notably, however, while nontraditional products have offered borrowers a variety of options, many of these products are not prevalent in the nonprime market. Payment-option loans are typically not available in the nonprime sector. In fact, according to Fitch Ratings, no nonprime loans carried a negative amortization feature in 2005. The IO share in the prime sector was 44 percent of dollar volumes, while it was 25 percent of dollar volumes in the nonprime sector. According to Standard & Poors, nonprime IO borrowers tend to have larger loans, typically indicating higher incomes, and better credit scores than nonprime borrowers who choose other products.

To be sure, as with all mortgage products, nontraditional mortgages must be underwritten by lenders in a safe and sound manner and their risks must be appropriately managed. As with other products, loan originators must provide consumers necessary information on a product's terms so a borrower can determine whether the product matches his or her needs.

Reports by MBA members and other data reviewed by MBA indicate that interest-only and payment-option mortgage borrowers also generally have good credit scores and relatively low loan-to-value (LTV) ratios. These products also tend to be most prevalent in higher cost areas of the country where there is a greater need for affordability products. For example, California, a particularly high cost state, has always had a high

ARM share. As the risk of a loan or its features increase - mortgage lenders take appropriate steps to offset the risk by requiring other features like higher credit scores to ensure a borrowers credit worthiness.

Interest-Only and Payment-Option Mortgages:

Interest-only and payment-option mortgages are two different products. Each is treated differently by lenders in terms of credit policy, underwriting standards and risk management.

An interest-only mortgage is commonly a loan under which a borrower is permitted to make interest-only payments for a certain period of time, after which the borrower is required to make principal payments as well. The interest rate may be fixed or adjustable during the interest-only period and may be fixed or adjustable after amortizing payments are required. Borrowers are typically allowed at their option to make principal payments during the interest-only period.

A payment-option mortgage is a loan for which a borrower typically has an option each month to make one of four payments: an amortizing payment based on a 15-year repayment schedule; an amortizing payment based on a 30-year repayment schedule; an interest-only payment; or a minimum payment based on a start rate which is below the fully-indexed accrual interest rate.

Where the minimum payment is insufficient to pay all of the interest due at the accrual interest rate, negative amortization occurs. Negative amortization means that the principal balance owed by the borrower increases. Typically, the minimum payment is fixed for 12 months, after which it adjusts annually based on the fully-indexed rate. Payment increases are usually limited to 7.5 percent in any one year. The amount of negative amortization may range from 10-25 percent of the original mortgage amount; if this limit is reached, the loan is recast, requiring payments that will amortize the outstanding balance over the remaining term of the mortgage.

B. ARMs and Hybrid ARMs

ARMs, including hybrid ARMs, are tried and true credit options. While some have asserted that they should be treated as nontraditional products, they are not covered by either the federal or state guidance for good reasons detailed in our recent letter to members of this committee. (For a fuller description of the guidance, please refer to page 10). They significantly differ from interest-only and payment-option products. ARMs, first developed in the 1970s, permit borrowers to lower their payments if they are willing to assume the risk of interest rate changes. Hybrid ARMs, introduced in the mid-1990s, combine the benefits of fixed rate mortgages and adjustable mortgages and allow borrowers to opt for a lower initial interest rate and lower monthly payments, which are fixed for a period of two to ten years (including 2-28 ARMs and ARMs with longer fixed payment periods). After the fixed payment period ends, the hybrid ARM converts to an adjustable rate mortgage with the interest rate and payments adjusting periodically (usually yearly) based on interest rate changes in the capital markets.

ARMs, including hybrid ARMs, are not simply refinancing tools; these mortgages are affordable financing options that have helped millions of borrowers achieve the dream of homeownership. Hybrid ARMs offer a lower monthly payment during the fixed payment period than a fixed rate mortgage. Nearly half, or 45 percent, of non-prime loans are purchase loans, with 25 percent of non-prime purchase mortgages originated for first-time homebuyers indicating that a significant portion of the recent gains in homeownership are likely attributable to hybrid ARMs. In the first half of 2006, 67 percent of new subprime loans were ARMs.

Hybrid ARMs are frequently underwritten using more flexible guidelines based on reasonable repayment expectations, allowing many more borrowers to qualify for these loans. Flexible underwriting for hybrid ARMs is appropriate. Relatively few hybrid ARMs experience any adjustment at all; hybrid ARMs are usually refinanced very early in their terms. Data from Fitch Ratings indicate that of the prime loans originated in 2003, only 44 percent remained outstanding as of the second quarter of 2006. For subprime loans originated in 2003, only 22 percent remain outstanding as of that time.

If ARMs and hybrid ARMs were underwritten to the fully-indexed rate, as some advocacy organizations assert, many hybrid ARM borrowers simply will not qualify for mortgages to buy homes or to get needed credit. For many borrowers, the choice is not between an ARM and a fixed rate mortgage to finance the property they want; it is an ARM or no mortgage at all.

Hybrid ARMs are not "exploding mortgages." Payment increases are generally much smaller than alleged and by virtue of borrowers moving or refinancing, frequently never come due. The rates and payments under hybrid ARMs do not normally increase by 40-50 percent, after the option period has expired, as has been alleged. In fact, whether there are any payment increases depends on the structure of the ARM and what happens to interest rates during the fixed period of the loan. Data from lenders demonstrate that today, on average, the change between the average start rate and the average fully indexed rate under these mortgages is generally no more than 2-3 percentage points. To protect borrowers from unmanageable payment increases, lenders structure hybrid ARMs so that there is a cap on the periodic adjustment. Also, as indicated, most subprime borrowers do not remain in their mortgages for more than three years. In any event, the potential increase in payments for borrowers later in the life of a hybrid ARM pales by comparison to the initial up-front savings to these borrowers.

C. Federal and State Nontraditional Guidance

On September 29, 2006, the federal financial regulators--the Board of Governors of the Federal Reserve (FRB), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC) and the

National Credit Union Administration (NCUA)—jointly issued Final Guidance on Nontraditional Mortgage Products (the Guidance).[2] Key aspects of the guidance are the same as the proposed guidance issued for comment by the regulators nearly nine months ago, with a few significant clarifications.

The Guidance is intended to address risks posed to federally regulated financial institutions by the growing use of mortgage products that allow borrowers to defer payments of principal and, sometimes, interest. The guidance specifically covers interest only (IO) and payment-option adjustable rate mortgages (Option ARMs). It specifically excludes HELOCs and reverse mortgages.

The guidance applies to federally regulated institutions including federally chartered banks, S&Ls and credit unions but it has a "trickle down" effect since it requires such institutions to monitor the quality of third party originations so they reflect the institutions' lending standards and compliance with laws and regulations.

The Guidance addresses three sets of concerns: (1) Loan Terms and Underwriting Standards; (2) Portfolio and Risk Management Practices; and (3) Consumer Protection Issues.

On November 14, 2006, Conference of State Bank Supervisors (CSBS) and American Association of Residential Mortgage Regulators (AARMR) encouraged the states to adopt guidance which generally tracked the Federal Guidance and, to this end, both organizations published their template as CSBS/AARMR Guidance. This guidance is based on the Federal Guidance, and only modified or deleted those provisions dealing with risk management that were inapplicable to non-depository institutions.

In their press announcement, the organizations noted that consistent guidance "will allow the opportunity to gauge the impact on the mortgage market and consumer behavior." As of this date, 23 states and the District of Columbia have adopted or begun the process of adopting the CSBS/AARMR guidance.

Mortgage lenders have been subject to a patchwork of lending requirements, in areas other than nontraditional products, emanating from the federal, state and even local governments. These diverse standards, while well-intentioned, have lessened competition, increased regulatory costs and, thereby, increased costs to the consumer. Restrictions that vary from locality to locality lessen the number of entrants that are willing to learn and comply with particular requirements. Increased regulatory risks and compliance costs for those who do compete translate into increased costs for consumers.

For this reason, MBA particularly appreciates the efforts of the regulators to develop guidance that is consistent among federal and state regulated institutions. Consistency of guidance better serves consumers, increases competition and lowers costs.

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[2] 71 Federal Register 58609 (October 4, 2006)
http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/attachment1.pdf

Recently, pressure has been exerted by some advocacy organizations to extend the Federal Guidance to ARM products, including hybrid ARMs, notwithstanding that neither the Federal Guidance nor the CSBS/AARMR Guidance encompass them.

MBA strongly believes that the federal and state guidance should not be expanded to go beyond nontraditional products (IO and Payment Option ARMS). Further, it should not be expanded to include hybrid ARMs or other traditional products. Again, the effect of such expansion will only serve to limit borrowers' options and increase costs.

As of yet, no regulatory action has been undertaken to expand the Federal Guidance. We understand, however, that the federal regulators are carefully considering this matter and we trust that before any additions are made to the guidance the public, industry, advocacy organizations and others would be afforded a full and fair opportunity for comment.

1. Underwriting Standards

The establishment of underwriting standards is the responsibility of lenders and mortgage investors who are constantly refining credit policies in response to risk analysis, market conditions, and consumer behavior. Certainly, the experience of many such institutions, which have offered a range of products for decades, has demonstrated an ability to develop safe and sound underwriting standards.

Mortgage lenders that successfully offer nontraditional products have used credit reports, credit scores, and sophisticated modeling to ensure that the non-amortizing features of nontraditional loans are mitigated with features that reduce risk.

While MBA and its members agree that borrowers should not be underwritten at teaser rates that are substantially below the fully-indexed accrual rate and are in effect for just the first few months of the mortgage, MBA has not favored the establishment of rigid, overly broad, underwriting standards that require analysis of borrowers' ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. We have commented that such an approach is far too prescriptive and forces lenders to apply credit policies that disadvantage products in a manner which is inconsistent with their risks.

The nontraditional guidance expects that interest-only and payment option mortgages be underwritten to the fully indexed rate, a result that will limit the availability of these products. The extension of this requirement to hybrid ARMs will have a similar effect. Moreover, under an approach requiring underwriting to the fully indexed rate, a 10/1 hybrid ARM with a 20-year amortization starting in year eleven would be disadvantaged against a 3/1 hybrid ARM with a 27-year amortization starting in year four despite the fact that most lenders would consider the 10/1 hybrid ARM a lower risk product.

A key risk factor of any hybrid mortgage is the initial length of time during which the interest rate is fixed, where an interest-only payment is required or the fact that the loan does not amortize. An overly broad standard may require lenders to invert this risk analysis and treat loans with a longer fixed rate or payment timeframe as higher risk than those with shorter timeframes.

2. Portfolio and Risk Management Practices

MBA and its' members share the view embodied in the guidance that lenders should pay particular attention to those products in their portfolios that may carry higher risks and change credit policies and risk management practices when performance problems arise or risk analysis indicates there may be a problem.

There is also agreement with the requirement that mortgage lenders should have appropriate controls in place for the types of mortgage products they originate.

Day-in day-out, lending institutions work internally and with their regulators to ensure that their loan loss reserves are adequate given the risks in their portfolios.

3. Borrower Information Concerning Nontraditional Products

MBA and its members strongly believe that the features of mortgage products offered to consumers should be fairly represented so that consumers can decide for themselves which product makes the most sense given their personal financial position. As indicated, many consumers understand the array of products and have used them appropriately to their advantage.

Because there is no single, uniform, mandated disclosure for nontraditional products, lenders have developed their own disclosures to inform borrowers about the characteristics of these products. Many mortgage lenders have been originating these products for a considerable amount of time and have significant experience with them. This experience has informed the development of disclosures.

Lenders also provide borrowers the range of information and disclosures mandated under the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA), including the Consumer Handbook on Adjustable-Rate Mortgages (CHARM) booklet.

MBA has reviewed the disclosures developed by several MBA members who originate significant volumes of nontraditional mortgages and have found them to be quite detailed and comprehensive in providing consumers the information they need to fully understand the mortgage product they are considering.

Mortgage lenders that successfully offer these products constantly review the performance of these loans. They make changes as warranted to credit policies and other practices, including disclosures, to improve performance and to facilitate customer understanding.

MBA's comments on the Proposed Federal Guidance and the Proposed Illustrations of Consumer Information on Nontraditional Products published contemporaneously with the federal nontraditional product guidance strongly urges that the regulators use the existing authorities under TILA to improve disclosures for nontraditional products nationwide.

Notwithstanding that the regulators determined that new information as set forth in the Guidance was needed now, to ensure that consumers get the information they need about nontraditional mortgages, MBA urges that the regulators regard the new disclosure illustrations as a temporary approach. MBA recommends that the regulators direct their energies toward a much more comprehensive approach to improving the mortgage disclosure process for consumers and make these disclosures applicable to all mortgage lenders.

Consumers today confront a pile of disclosures when they apply for and close on a mortgage. Sadly, every new layer of disclosure simply increases the likelihood that the consumer will merely initial all of them without even a cursory reading. For this reason, disclosures do not need to be added; they need to be combined, streamlined and made much more user friendly.

Efforts at improvement should include all disclosures required by federal law. Because RESPA and TILA apply to regulated and unregulated entities, such an approach is the best means of assuring that virtually all consumers receive high quality information and that a level playing field of disclosure requirements is established for all industry originators. These efforts should also consider the plethora of state disclosures.

In the meantime, MBA and its members are currently implementing the Guidance. Notably, however, MBA members have long established underwriting standards, risk management and appropriate consumer protections for these and all mortgage products.

MBA strongly believes that sound underwriting, risk management and consumer information are essential to the public interest. At the same time, we also believe that it is essential to assure the legislative and regulatory environment serves and does not choke innovation in the industry and reduce credit options for borrowers. Such an environment allows lenders to provide borrowers the widest array of credit options to purchase, maintain and, as needed, draw equity from their homes to meet the demands of their lives.

D. Financing Tools

The following valuable financing options allow consumers to make their mortgage more affordable:

Prepayment Penalties

A prepayment penalty in connection with a mortgage allows a borrower to choose a lower rate and lower monthly payments in return for agreeing not to refinance within a set period unless he or she pays a fee. A lower rate can be offered because the presence of a prepayment penalty assures a more reliable income stream for investors in pools of such mortgages and, consequently, better pricing for securities and consumers themselves.

MBA has long been committed to transparency and informed consumer choice and, in that vein, believes that prepayment penalties should always be optional and result from true consumer choice. Accordingly, MBA would support a requirement as part of a uniform lending standard that originators provide borrowers with a choice of a loan rate with and without a prepayment penalty, if available.

Yield Spread Premiums

Yield spread premiums represent the value of any difference in rate between the rate the customer pays a mortgage broker and the current par (going) rate accepted by secondary market investors. Unlike prepayment penalties that reduce the interest rate, yield spread premiums increase the rate to receive credit back on the transaction to pay for closing and origination costs. As (HUD) recognized in considering the legality of yield spread premiums, these payments offer borrowers the option of choosing to defray origination costs by selecting a higher rate and therefore, higher monthly payments instead of paying them up front. MBA favors their disclosure to borrowers but also believes they are important options that should remain available.

E. Lenders Rely on Accurate Appraisals

Lenders have every incentive to ensure that property appraisals are accurate because they bear the risk of loss. The lender relies on the appraisal as a true reflection of the value of a property and agrees to lend a particular amount to a borrower based on the appraisal. To assure the veracity of the appraisal and the fair dealing of appraisers, MBA supports the proper licensing of appraisers. Further, lenders have developed and utilized automated valuation models (AVMs) which are objective programs that provide accurate valuations of a particular property. Lenders represent and warrant to investors that the appraisal is accurate. If it is discovered to be inaccurate, a lender can be forced to buy the loan back.

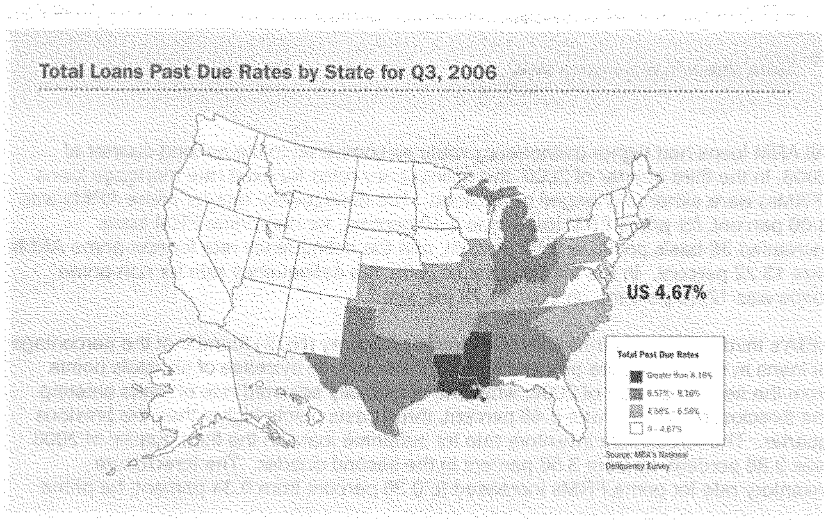
III. THE PRIMARY REASON FOR DEFAULTS ARE FAMILY AND ECONOMIC DIFFICULTIES – NOT PRODUCT CHOICES

There is no evidence that product choices by borrowers are determinative of defaults or foreclosures. Different products have different default rates but the product choice does not cause the default. Data consistently demonstrate that delinquencies among all borrowers are a function of a variety of factors including, first and foremost, economic difficulties caused by job losses. According to Freddie Mac, based on a sample of loans in Workout Prospector®, from 1999 to 2005, the following are the reasons for delinquency:

Reasons for Delinquency

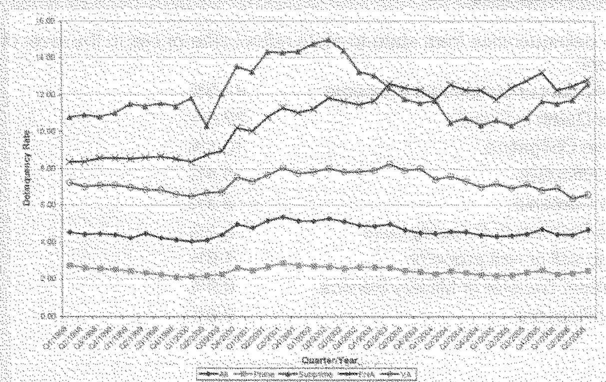
Variations in delinquencies from state-to-state reflect differences in the level of unemployment:

Unemployment or curtailment of Income	41.5%
Illness or Death in Family	22.8%
Excessive Obligation	10.4%
Marital Difficulties	8.4%
Extreme Hardship	3.3%
Property Problem or Casualty Loss	2.1%
Inability to sell or rent property	1.6%
Employment Transfer or Military Service	0.9%
All Other Reasons	9.0%



Assertions that delinquency rates are at crisis levels and a greater percentage of borrowers are losing their homes are not supported by data. In fact, delinquency and foreclosure rates, including nonprime borrowers, have remained relatively low with some increases over the last year.

Total Delinquency Rate by Loan Type



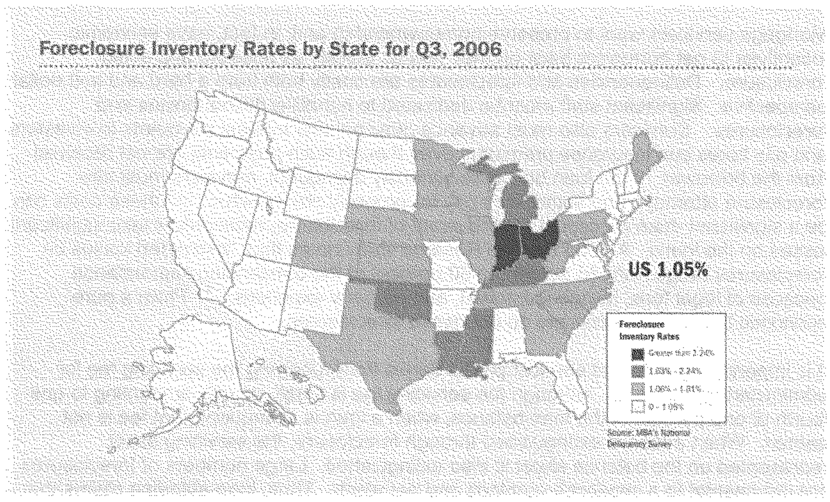
Source: MBA's National Delinquency Survey

All ARM loans had higher delinquency rates as compared to the second quarter of 2006. In the third quarter of 2006, the delinquency rates for fixed rate mortgage loans (FRMs) were either unchanged or declined. The delinquency rate for prime ARMs was 3.06 percent, for prime FRM loans was 2.10 percent, for non-prime FRM loans increased 36 basis points to 9.59 percent, and the delinquency rate for non-prime ARMs was 13.22 percent. In the third quarter of 2006, the delinquency rate for non-prime loans was 12.56 percent, up from 11.70 percent.[3]

MBA's third quarter 2006 National Delinquency Survey (NDS) found that the percentage of loans in the foreclosure process was 1.05 percent, an increase of six basis points from the second quarter of 2006, while the seasonally adjusted rate of loans entering the foreclosure process was 0.46 percent, three basis points higher than the previous quarter. The foreclosure inventory rate for subprime loans in the third quarter of 2006 was 3.86 percent, up from 3.56 percent in the second quarter. The foreclosure inventory rate for prime FRMs increased to 0.36 percent from 0.34 percent, for prime

[3] These figures are based on MBA data. MBA defines "delinquency" as having one or more payments overdue. The loans in foreclosure are approximately a third of these numbers and the borrowers actually losing their homes are approximately a fourth of that group.

ARMs from 0.56 percent to 0.70 percent, for non-prime ARMs from 3.88 percent to 4.68 percent. The foreclosure inventory rate decreased for subprime FRM loans from 3.05 percent to 3.00 percent.



In its most recent data, MBA is seeing increases in delinquencies and foreclosures for nonprime loans, particularly nonprime ARMs. Because of technology induced cost reduction and efficiency gains by the industry as well as the appetites of borrowers for credit, the share of outstanding loans that are non-prime has been increasing for the last several years. The higher average delinquency and foreclosure rates among these loans mean the overall statistics for total outstanding mortgages are unlikely to fall as low as in the past.

It is important to note that non-prime loans have always had higher delinquency and foreclosure rates and lenders factor in these risks when lending to non-prime borrowers. Given the fact that nonprime borrowers have weaker credit profiles, this is not surprising. Foreclosures also can be accelerated by slow housing markets that limit borrowers' ability to quickly sell in order to cover their losses. MBA data has indicated that over the last several quarters a number of factors, including the aging of the portfolio, increasing short-term interest rates and high energy prices, have been putting upward pressure on delinquency rates. However, healthy economic growth and vibrant labor markets have offset these pressures.

Nevertheless, for each borrower whose loan goes into default and is foreclosed, the experience is a traumatic one, and it is not surprising that counsel for such borrowers would assert every claim available to permit their clients to hold onto their homes.

However, policymakers need to understand that keeping the homeowner in their home paying on their mortgage is the best outcome for both the lender and the borrower.

IV. FORECLOSURE PREVENTION AND SERVICING PRACTICES

Mortgage servicers want to preserve homeownership and, in fact, have economic incentives to get borrowers back on their feet as quickly as possible and avoid foreclosure. Delinquencies and foreclosures are costly both from a hard and soft dollar perspective. Significant staff must be dedicated to handling delinquencies and foreclosures. Servicers also must advance principal and interest payments to investors and pay taxes and insurance premiums even though such payments are not received from the borrower. If the loan becomes seriously delinquent, servicers must hire foreclosure attorneys and sometimes pay for property preservation. All these costs can be a significant drain on capital. In the event of foreclosure, noteholders take significant losses on the loans. A 2003 Federal Reserve study notes that, "estimated losses on foreclosures range from 30 percent to 60 percent of the outstanding loan balance because of legal fees, foregone interest, and property expenses." [4] From a pure economic basis alone servicers do not desire foreclosures.

It is important to note that servicer profits derive from receiving the servicing fee for administering the loans. Although the servicing fee is small, usually amounting to one-fourth of one percent of the loan balance, when a loan is delinquent, that fee is not earned. When a loan is extinguished through foreclosure, the servicing asset represented on the balance sheet is also extinguished. Large numbers of foreclosures are detrimental to a servicer's earnings and net worth. Thus, long-standing claims that lenders purposely put borrowers into products they cannot afford in order to take the property through foreclosure is simply unfounded.

In reality, everyone loses in a foreclosure – the borrower, the local community, the mortgage insurer, investors and the servicer. Servicers do not have an incentive to intentionally cause foreclosures, because profitability rests in keeping loans current and, as such, the interests of borrowers and lenders are mostly aligned.

A. Loss Mitigation Tools

Recognizing the significant downside to foreclosures and with a strong desire to assist their borrowers, servicers have, over the last fifteen years, made deliberate and significant strides to provide workout alternatives to foreclosure. These alternatives include both home retention options, such as forbearance, repayment plans and modifications, and home relinquishment options when the borrower can no longer support the debt. Of course, servicers strive to provide home retention solutions whenever possible. The following is a brief overview of the home retention options used by servicers:

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[4] Foreclosing on Opportunity: State Laws and Mortgage Credit, Karen M. Pence, Board of Governors of the Federal Reserve System, May 13, 2003.

- **Informal Forbearance Plans:** These plans provide short-term postponements or reductions in payments with a typical duration of three months, followed by repayment of the arrearage over time.

- **Special Forbearance Plans:** These plans are longer-term forbearance plans that typically combine a period of postponed or reduced payments followed by repayment of the arrearage over an extended time frame. There is usually a cap on the amount of PITI (principle, interest, taxes and insurance) payments that can be deferred. The industry average is 12 – 18 months PITI. Extensions are handled on a case-by-case basis.

- **Loan Modification:** Modifications result in permanent changes to one or more of the original loan terms, such as the interest rate and/or duration of the loan. A modification is a very effective work out vehicle, because it provides an immediate resolution to the delinquency by taking the amount of arrearage and adding it to the balance of the modified loan (e.g. "capitalize the arrearage") and re-amortizing the payments. The duration of the loan can also be extended to reduce monthly payments.

- **Delinquent Refinance:** Although less common, borrowers that are less than three months behind may be able to refinance to lower rates and capitalize the arrearage.

- **Partial Claims:** FHA borrowers have an added tool called a partial claim. HUD will accept a junior loan that is comprised of the amount of arrearage. This junior loan bears no interest and is repayable upon pay-off of the first mortgage. The servicer "advances" the amount of the arrearage to the borrower's account and makes a "partial" claim to HUD for the amount of the advance.

Other non-home retention loss mitigation alternatives are useful when borrowers have no viable means to cure their financial situation. These options offer several benefits that should not be discounted. First, they avoid foreclosure which can severely impact the borrower's credit. Second, the servicer generally does not seek repayment of the deficiency, which is the difference between the value received for the property and the amount of the debt owed. Third, borrowers are often assisted with moving expenses. These options are most often used when home prices decline below the amount of outstanding debt:

- **Pre-Foreclosure Sale (PFS) or Short Sale:** Proceeds from a third party sale of the borrower's home are accepted as satisfaction for the mortgage, even though they represent less than the amount owed.

- **Deed-in-Lieu of Foreclosure (DIL)**: The borrower voluntarily deeds the property to the servicer as satisfaction for the mortgage even though the value of the property is less than the amount owed.

The success of these loss mitigation programs is a reality in terms of keeping borrowers in their homes. Mortgage lenders work hard at devising ways to reach consumers at an early enough point to work out a feasible approach in light of a consumer's situation.

B. Servicer Practices

Before borrowers ever reach the point of being seriously delinquent, servicers attempt to cure the delinquency. Experience has shown that early intervention is the key to curing delinquencies. As a result, servicers make significant attempts to contact borrowers early in the delinquency or even before a delinquency occurs. In fact, prime lenders have adopted some techniques from subprime lenders that have proven effective, including: providing welcome calls to new customers ensuring that they have important contact information; initiating reminder calls prior to the expiration of the grace period for at-risk borrowers; using automation to determine when a borrower's failure to make a payment is outside of their normal pay-behavior; and prioritizing out-bound assistance calls to the highest risk delinquent borrowers first. This allows servicing staff to focus their resources where they are most needed. These techniques have proven to be beneficial for consumers. In addition to personal contact, servicers send numerous notices to borrowers informing them of their delinquency, offering loss mitigation and providing helpful information on how to avoid foreclosure. Property preservation personnel in some cases also leave discrete information at the property address.[5]

Some servicers are also using telecommunication tools to streamline contact with delinquent borrowers. Through automation, the delinquency status of in-bound callers can be determined very quickly and calls routed automatically to workout staff thus by-passing the company's standard customer service line. The process is seamless to the consumer and avoids wait times. Other companies provide dedicated toll-free numbers that go directly to the loss mitigation teams trained to address more complex borrower needs.

Servicers have also developed websites that allow borrowers to access loss mitigation information, obtain and submit required documents and in some cases, apply for loss mitigation on line.

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[5] The following are the notices/solicitations typically provided by servicers: a payment reminder that payment is past due (from 2-16th) (this is typically for high risk borrowers); late charge notice notifying the customer that payment is past due and late charge has been assessed; monthly account statement reflecting either the current and/or total amount past due; notice of availability of counseling and state/local payment assistance programs at 45 days (Federal Law); mail "How to Save Your Home" pamphlet at 60 days (Federal Law for FHA loans); mail internally created documents on how to save the home for non-FHA loans; separate letters soliciting for loss mitigation; multiple calls each month to solicit alternative collection/loss mitigation. Additional notifications are sent pursuant to state statutory requirements or preconditions to foreclosure including the breach (or demand letter); letter announcing acceleration of the debt; service of process notices, and foreclosure sale date.

Unfortunately, despite all this technology and effort, over half of borrowers in foreclosure proceedings have had no contact with their servicer.[6] This lack of contact is one of the biggest challenges servicers face in trying to cure delinquencies.

One situation that MBA believes contributes to this low contact rate is a provision in the Fair Debt Collection Practices Act (FDCPA). Under FDCPA, a lender who purchases servicing on a delinquent loan is required to announce itself as a "debt collector" prior to discussions with that customer. A servicer who purchases current servicing that subsequently becomes delinquent, however, is not required to make this announcement. This so-called "mini Miranda warning" effectively drives borrowers away by creating a misleading and conflicting message with loss mitigation efforts (especially when servicers request financial information from the borrower for purposes of structuring the loss mitigation plan). Servicers that purchase delinquent servicing should be treated like other servicers and not have to provide this statement. It is counterproductive.

Even with these obstacles, servicers are not just throwing in the towel. They are proactive in exploring new options that bring borrowers to the table - ways that create approachable environments for borrowers who might be embarrassed or not trusting of the lender. This includes teaming up with non-profit and for-profit agencies to assist in *locating* borrowers and providing homeownership counseling.

One such effort is a joint venture between NeighborWorks America, the Homeownership Preservation Foundation (HPF), the Ad Council and approximately 17 nationwide servicers, insurance companies and other industry representatives. The partnership is funding a nationwide campaign to inform and educate homeowners about the availability of foreclosure prevention counseling. The partnership links the HPF's 1-888-995-HOPE toll-free hotline, which offers free telephonic foreclosure prevention counseling with NeighborWorks' network of "on the ground" organizations that provide face-to-face homeownership counseling services when telephone counseling is not enough. With the assistance of the Ad Council, the partnership will fund a nationwide public service campaign aimed at encouraging homeowners to contact 1-888-995-HOPE to receive foreclosure prevention counseling. Counselors will work with borrowers and their servicers, even those that are not part of the partnership, to execute loss mitigation arrangements. The hope is that homeowners who are hesitant to call their servicers will be more likely to contact a non-profit organization to discuss alternatives.

This recent joint venture is modeled after Chicago's Homeownership Preservation Initiative (HOPI) that encourages homeowners facing foreclosure to call the city of Chicago's 311 hotline to be linked to non-profit credit counseling agencies. The HOPI program and the subsequent national partnership has resulted in increased communication strategies by servicers and the industry's ability to inform non-

[6] Foreclosure Avoidance Research, Freddie Mac, 2005.

profits across the country about servicers' creative and flexible loss mitigation options that are generally available to borrowers in danger of foreclosure.

The paradigm has shifted from a decade ago. Borrowers need to know that lenders can help. A direct call to the lender or to a reputable housing counselor can save a borrower's home. We hope to facilitate that message whenever possible.

C. Concerns with Mandatory Forbearance

MBA understands that the Committee is exploring other ways to reduce foreclosures. Let me assure you that the mortgage banking industry is willing and eager to embrace new opportunities, but MBA implores you to keep in mind that those alternatives must be simple, cost effective for all parties and have reasonable probabilities of success.

Of significant concern are recent press stories suggesting a statutorily mandated forbearance period. The length and trigger of such a forbearance period is unknown at this time, but MBA is very concerned that such a proposal would prevent or delay lenders from taking important statutorily required steps, such as sending breach letters, accelerating the debt, or initiating foreclosure. Forbearance, while well intentioned, may have unintended results when applied across the board, and will certainly delay already lengthy foreclosure time frames.

First and foremost, it is unclear that mandatory forbearance will increase the number of cures over current volumes. Historically there is very little success with curing loans where the property is abandoned, converted to rental properties but no longer profitable, damaged or subject to code violations, or where the borrower simply no longer has the means to support the loan at any level or to perform a short sale . Delaying the inevitable foreclosure only add costs for borrowers and lenders in these cases. There is simply no way to cure these delinquencies and therefore going to foreclosure is really the only solution.

Second, holding off foreclosure, when it is really the only path, often results in the deterioration of properties and ultimately affects entire neighborhoods. Crime increases and other property values are impacted. Servicers must have discretion to move to foreclosure according to state time frames that have been established and vetted over many years.

Third, any mandated forbearance period, by its very nature, will increase the number of loans that move into the severely delinquent loan category (90 or more days delinquent) and remain there. Under risk-based capital rules, loans that are 90 days or more past due are subject to a 100 percent risk weighting (as compared to loans that are current or below 90 days delinquent, which carry a 50 percent risk weighting). A broad application of a forbearance period could affect financial institution's capital requirements and rankings.

Fourth, there is significant time already built into the delinquency and foreclosure process for borrowers to cure their problems. Cases are generally not referred to a foreclosure attorney until the loan is 90 days past due. Servicers must then prepare and refer the file to a foreclosure attorney. The foreclosure attorney must prepare the petition for foreclosure and file it with the appropriate court or begin the statutorily prescribed notices that pre-condition non-judicial foreclosure. Service of process and hearings follow. This is not a quick process. In New York, for example, it takes approximately 12 months from the petition filing date to reach foreclosure sale. In Pennsylvania, it takes approximately 10 months. Foreclosure timelines are shorter in non-judicial states and those processes have been developed and vetted by the state legislatures over many decades. It is important to stress that servicers continue to solicit borrowers for loss mitigation even when the loan is "in foreclosure." In fact, servicers will execute a viable loss mitigation arrangement up to the foreclosure sale date. Some states also offer redemption periods that allow a borrower to tender payment to the servicer after the foreclosure sale is complete and get the property back. Diligent borrowers have sufficient time already to clear up a delinquency if other financial factors are present (including loss mitigation).

Fifth, foreclosure delays can result in negative tax consequences for borrowers. Accrued interest, taxes, insurance premiums, foreclosure costs and other incurred fees continue to mount the longer the loan is delinquent. These amounts become part of the borrower's total indebtedness. Under the Internal Revenue Code, if the lender "writes off" the borrower's debt following foreclosure, a borrower who is solvent and has recourse liability under the tax code is considered to be enriched by the amount of the "debt forgiven" and is taxed on that amount as if it were ordinary income. Any forbearance period that delays the foreclosure sale will increase the borrower's debt and exacerbate the negative tax consequences for borrowers. As a result, forbearance for all borrowers, even those that cannot resolve their delinquency by any means, is not a sound alternative.

Sixth, a mandatory forbearance law may unintentionally harm the borrower's ability to recover. Servicers know that the longer the borrower remains delinquent, the less likely he or she will be able to cure the delinquency. A mandatory forbearance law that gives no discretion to the lender and encourages borrowers to remain delinquent will harm borrowers' chances of recovery.

It is also important to remember that foreclosures take longer in judicial foreclosure states. A 2003 Federal Reserve Board working paper notes that, on average, foreclosures in judicial foreclosure states take 148 days longer than non-judicial foreclosure states. Because it takes longer for foreclosures to be handled in the judicial states, their inventories at the end of each period tend to be higher. [7]

The mortgage industry has been responsive to its customers and has an interest in preserving homeownership. MBA urges this Committee not to impose an artificial

[7] Karen Pence, 2003, "Foreclosing on Opportunity: State Laws and Mortgage Credit." Federal Reserve Working Paper #2003-16.

forbearance period without consideration of the concerns above, and without consideration of the fact that loss mitigation is prevalent and effective.

V. THE IMPOSITION OF A SUITABILITY STANDARD HURTS THOSE IT IS MEANT TO HELP

As indicated, the data does not show that unsuitable products or predatory lending are the cause of delinquencies and foreclosures. The foreclosure problem is based on economic difficulties that confront borrowers.

Notwithstanding, a number of advocacy organizations have urged that a "suitability standard" be imposed on mortgage lenders as a means of making the lender responsible for assuring the borrower is in the right loan to prevent foreclosure later. These organizations assert that a "suitability standard" applies to securities brokers and that there is no reason why a similar standard should not be imposed on mortgage lenders. MBA disagrees.

While a specific proposal for a "suitability standard" for the mortgage industry is not yet fully formed, a variety of approaches have been suggested. Most would simultaneously require more rigid, prescribed underwriting standards, a duty of fair dealing at the inception of the loan, a subjective evaluation by the lender whether a product is best suited for that borrower, the establishment of a fiduciary obligation by the lender to the borrower and a private right of action to redress any violations. Some suggest that a regulator be empowered to specify the parameters of the requirement.

While many of points might sound good at first, on closer examination of the facts, they each raise very significant concerns for consumers. MBA published a paper within the last two weeks which MBA offers for inclusion in the record exploring many of these issues.[8]

In general, the paper explains why the imposition of a "suitability standard" on the mortgage lending industry risks unintended, negative consequences for consumers that would turn back the clock on hard won fair lending and homeownership gains. Congress should resist pressure to enact a suitability standard for the mortgage lending industry and, instead, should turn its attention to the creation of a uniform national lending standard. A uniform national standard would be the best approach to improve financial literacy, simplify disclosures to consumers in the mortgage process, and establish clear, objective standards to stop lending abuses without impeding the market's vitality and its ability to innovate to benefit consumers.

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[8] MBA Policy Paper Series, Policy Paper 2007-1, "Suitability, Don't Turn Back the Clock on Fair Lending and Homeownership Gains."

A. Rigid Hard Wired Underwriting Standards Deny Credit Options to Borrowers

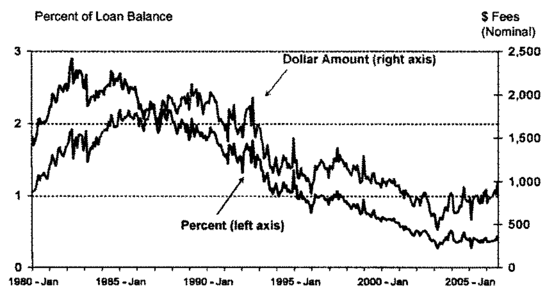
The most recent data provided by the mortgage lending industry under the Home Mortgage Disclosure Act (HMDA), on loans made in 2004 and 2005, demonstrate the greatest and widest availability of mortgage finance in our nation's history, which in turn has made possible record homeownership rates. The data show that borrowers in virtually every area of the nation, of every race and ethnicity, and at every income level receive an unparalleled array of credit opportunities.

MBA believes it important to remember how we got to this point. The confluence of several factors has contributed to the growth in credit opportunities for prime and nonprime borrowers over the last 15 years. These factors include increased competition from an unparalleled number of loan originators including mortgage companies, banks, credit unions and mortgage brokers. They also include innovations in the mortgage market, resulting in the range of mortgage products available today including fixed-rate products and adjustable rate products as well as "nontraditional." [9]

Most importantly, the past 15 years has been marked by dramatic changes in the mortgage origination process made possible by technology. Computerization has enabled a much greater understanding of default risk and the development of objective underwriting criteria. It has also permitted the embodiment of these criteria in automated underwriting tools and the growth of risk-based pricing. As shown in the chart below, according to the Federal Housing Finance Board's data from their Monthly Interest Rate Survey, the costs of originating a mortgage have declined tremendously both measured as a percentage of the loan balance and in nominal dollars.

[9] Under the Federal Regulators' Nontraditional Guidance, nontraditional products include mortgages that may involve the deferral of principal and/or interest including interest only and payment-option mortgages. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

Initial Fees and Charges on
Conventional Purchase Mortgage Loans



Source: Federal Housing Finance Board

Risk-based pricing, in turn, has permitted the development of a market to serve the needs of nonprime borrowers "who have difficulty in meeting the underwriting criteria of 'prime' lenders because of blemished credit histories or other aspects of their profile."[10]

Rigid new underwriting standards, no matter how well intentioned – even as innocuous as requiring a particular debt-to-income ratio, to ensure a borrower's ability to repay, for example – will result in denying some borrowers' credit who would otherwise qualify in today's market. Some of these borrowers will even be denied homeownership although they would qualify today. The magic of today's market is that the widest range of borrowers can get the widest spectrum of loans.

Similarly, while it might sound reasonable to require that all borrowers contending for a hybrid adjustable rate mortgage (ARM) - that allow lower fixed payments for an initial period and higher payments after that--be qualified at the fully indexed rate, such an approach will lock some borrowers out of the home of their dreams and deprive them of lower payments. It would also have the consequence of failing to allow these borrowers an opportunity to repair their credit so they can refinance into a lower priced prime loan before the rate adjusts. Moreover, ARMs, which have lower initial mortgage payments, and the potential for payment reductions if interest rates decline, allow borrowers to allocate more of their cash flow to other uses. For example, a borrower who saves on their mortgage payment can put more funds towards financial investments, potentially diversifying their overall portfolio.

[10] Remarks by Governor Edward M. Gramlich at the Federal Reserve Bank of Philadelphia, Community and Consumer Affairs Department Conference on Predatory Lending, Philadelphia, Pennsylvania (December 6, 2000).

It is important to be clear that in many cases the alternative to a flexibly underwritten adjustable nonprime mortgage product is not a fixed rate loan for many borrowers, but rather no loan at all at least for the property the borrower wants. All borrowers simply do not qualify for a fixed rate loan to finance the home because the payments are initially higher.

Some insist that the borrower like the one described who can not meet fixed ratios should be denied credit if they don't satisfy a particular test. Such a result is unnecessary in today's financing world. Also, respectfully, MBA wonders if that opportunity should be withheld from 87% of borrowers, including those who qualified for non-prime loans who are making their payments and achieving the dream of homeownership.

Today borrowers at virtually all points on the credit spectrum qualify for loans. The imposition of new rigid standards would change that and not for the good.

B. The Imposition of a Suitability Standard Risks Unintended Consequences

While certainly not intended to promote or authorize discrimination or reignite redlining, MBA is extremely concerned that the injection of subjective standards into the mortgage process would conflict with and potentially threaten fair lending, community reinvestment and homeownership gains particularly for first time homeowners and minorities.

The reason this would happen is not because anyone has bad motives but because new subjectivity would be injected into the market, the risks would increase markedly, driving many to be much more cautious or even to withdraw from the market. Lessened competition and increased risks will decrease financing options and increase costs.

Since the 1990's, the denial rates of African-American loan applicants, though still greater than white borrowers, have declined considerably. In 1992, the denial rate for conventional home purchase loans for African-American borrowers was 36 percent and in 2004 it was 24.7 percent. While there has been some increase in the institutions covered by HMDA over these years, the number of applications nearly quadrupled over this period.[11]

Although all homeownership has increased since the 1990s, the percentage increase in African-American homeownership has been greater than among whites and the national average. The African-American homeownership rate has increased almost six percentage points since 1994, while the overall rate has increased nearly five percentage points. If a subjective suitability standard is imposed, in the first instance, lenders will be required to assure that a loan is suited for the borrower. If such a standard is imposed, a lender facing a mortgage applicant who is a member of a

[11] 1992 and 2004 HMDA data.

protected class, and for whom a loan product may be "unsuitable," might deny the borrower credit options to conform to the suitability requirement and, at the same time, violate the letter and spirit of fair lending and community investment requirements. Conversely, if credit is extended, the lender risks violating a suitability requirement.

Either way, by injecting ***subjective*** standards into the process, there will be much greater caution by lenders and less competition in the market as lenders shy away from these risks. There is real concern that subjectivity and even caution will disproportionately affect first-time homeowners, minorities and those with less wealth where suitability and fair lending concerns intersect.

Even if the facts suggest that a lender is in compliance with both fair lending rules and a suitability requirement, borrowers who go into default are likely to claim that the loan was "unsuitable." This new cause of action will also drive lenders out of markets, lessening the availability of credit and driving up costs for consumers. It would seem that only the lawyers will benefit.

Although as indicated, advocacy organizations point to the securities industry as a model for a suitability standard, on examination, the industries are not analogous. Their business models differ and so do the policy imperatives that govern them.

While federal policy has been to encourage mortgage lenders to make credit available to as many borrowers as possible, by contrast those responsible for regulation of the securities industry have not made expansion of investment opportunities to underserved persons or neighborhoods a major policy initiative. The consequence of the suitability requirement for a securities firm is that overly cautious broker-dealers will lose out on commissions. The consequence of a suitability requirement for mortgage lenders is that overly cautious lenders may violate the letter of federal anti-discrimination laws and the spirit of community reinvestment laws.

As far as the business models are concerned, securities broker-dealers function as intermediaries between their customer and the market to invest their customers' money; broker-dealers hold themselves out as investment consultants. Mortgage lenders, on the other hand, represent their companies and investors whose money they put at risk to make loans to borrowers; they do not function as agents or fiduciaries and they do not hold themselves out as such to borrowers. Consumers select their securities advisor on a long-term basis, but regularly shop among mortgage lenders when seeking a mortgage.

It is noteworthy that survey data indicates that an intrusion by lenders into the borrower's personal decisions is unwelcome by the borrower whom a suitability standard would be designed to protect. One recent study found that 88 percent of respondents would prefer to "decide for themselves whether or not a mortgage product is right for them, rather than leaving that responsibility to the mortgage lender."[12]

Also notably, borrowers subject to a pilot program in the City of Chicago that imposes mandatory financial counseling only for borrowers in specific ZIP codes have filed a law suit alleging that the program amounts to "state-sanctioned redlining."[13] Governor Blagojevich suspended this law on Friday, January 19, recognizing that it was hurting the people it was designed to protect, according to The Chicago-Sun Times.[14]

Lenders can and do offer valuable information to consumers. Lenders help consumers understand what mortgage products are available and for what mortgages they may qualify. For this reason, it pays for consumers to see lenders early in the home buying process, not only to determine what property they can afford, but also to consider their financing choices in relation to their particular situations, including their incomes, credit and plans to stay in their homes. Nevertheless, lenders cannot serve as agents and fiduciaries for borrowers as well as for their companies.

Despite the wide range of market innovations, some borrowers have obtained loans with terms that negatively impact their ability to repay. Let us assure you, the fundamental goal that borrowers only obtain loans they can repay is shared by consumers, advocacy organizations, regulators and mortgage lenders alike. For this reason, the mortgage lending industry has a great stake in striving, along with advocacy organizations, legislators and regulators, to make the lending process as understandable and abuse-free as possible and more work is needed toward this goal. However, imposing a suitability standard is not an appropriate solution and would run the risk of turning back the clock on innovations that have greatly expanded home ownership opportunities.

Congress, therefore, should resist pressure to enact a suitability standard which would harm consumers. Retaining the current "arms length" transaction model in the mortgage lending industry works best.

VI. STEPS CONGRESS CAN TAKE TO PROTECT CONSUMERS

There are at least three things Congress can do to help consumers become better informed through the mortgage process, protect themselves and help them make the best choice for themselves.

First, considerable resources should be committed to improving borrower education to raise the level of financial literacy, including incorporating this issue into general educational programs and increasing access to transaction-specific borrower counseling. It would be a worthy undertaking to conduct a review of total government

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[12] *See* American Financial Services Association Press Release, "Borrowers, Not Lenders, Should Decide Appropriateness of Mortgage Products, Finds Survey," (Nov. 20, 2006).

[13] *See* Mary Umberger, "Home Buyer Counseling Challenged," Chicago Tribune, Nov. 2, 2006.

[14] *See* Lisa Donovan, "Gov Halts Mortgage Counseling," Chicago Sun-Times, January 21, 2007.

efforts in the area of financial literacy to see what is working is what is not. This study could also include the amount of resources expended for this purpose. MBA believes that better financial education would empower all borrowers to shop effectively among the array of competitors in the marketplace.

Second, simplification of the mortgage process and all necessary consumer information would make it much easier for an empowered consumer to navigate the market, and such improvements are long overdue. Consumers today face a pile of disclosures when they apply for and close on a mortgage. Efforts at improvement need to streamline the existing mandated disclosures and information, and must be comprehensive and well considered. A successful effort would result in much more effective information on the benefits, costs and features of the loan options presented by lenders. It would also go a long way to help borrowers shop for mortgages among lenders with an ability to make an apples-to-apples comparison.

Third, uniform lending standards that are clear and objective, but do not unduly restrict the market, would improve on the standards established under HOEPA to stop lending abuses. These standards must be national in scope to enhance competition in all markets for all borrowers, especially nonprime. Such standards will allow all borrowers to benefit from greater choices, competition and lower prices that a fair and fully functioning market brings. MBA would support the expansion of the types to loans to be covered in a uniform national standard to include purchase money loans and open-ended lines of credit.

MBA supports the framework for a national standard that includes the following principles and components.

Broad Principles of a National Standard:

- Uniform National Standard. A national law should recognize a national mortgage market by including broad preemption that facilitates competition and market efficiencies leading to low cost mortgage lending. It should apply to all lenders creating uniformity in the market. It should not change the current regulatory oversight, preemption or enforcement regime of those regulated by the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC).
- Protect Financing Options. The innovation of lenders to make mortgage credit more widely available through a variety of products and financing tools should be protected. Unduly limiting or outlawing finance options could put homeownership out of borrowers' reach, particularly underserved borrowers.
- Risk-based Pricing. Lenders' ability to efficiently price loans based on the risk of non-payment presented by a borrower has revolutionized and expanded the availability of mortgage credit. Through risk-based pricing, mortgage credit is more widely available to borrowers, especially to traditionally underserved

communities. A national standard should recognize and protect the benefits of risk-based pricing.

- A Suitability Standard Should Not Be Imposed. Certain groups have suggested imposing a suitability standard on mortgage lenders. Lenders already make a "suitability" determination through assessing affordability when underwriting a consumer's ability to repay a loan. A suitability standard beyond that threatens progress made in fair lending as well as the availability and affordability of credit to homeowners by reintroducing a subjective determination into a loan officer's work. Further, the imposition of a suitability standard exposes lenders to significant liability and will increase the cost of mortgage credit since it could affect the mortgage-backed security marketplace.
- Objective Standards. The provisions of any national standard passed by Congress should include clear, objective standards so that consumers understand their rights and protections and lenders understand compliance requirements.
- Added Consumer Protections: MBA supports increased protections for consumers in a national standard.

Components of a National Standard:

A. HOEPA Triggers:

- Reasonable High Cost Loan Triggers. Almost no lenders will make loans that meet the HOEPA high cost loan triggers because of the significant liability that attaches. Investors will not buy high cost loans because of the liability, which dried up liquidity for these loans. The triggers, therefore, act as a de facto usury ceiling in that lenders won't make loans above the triggers. Therefore, the APR and point and fee triggers should be maintained at their current levels so that legitimate lending is not cut off. MBA would support the setting of triggers at a reasonable level to help assure that mortgage credit continues to be available to credit-worthy borrowers.
- Point and Fee Definition Should Not Be Overly Broad. A national standard should maintain the items included in HOEPA for making the point and fee calculation. Neither prepayment penalties, nor yield spread premiums should be included in the definition because doing so would threaten the use of these finance options and because the value of those items is already reflected in the interest rate and APR. Thus, including those items in a points and fees test would result in double counting. Lowering the point and fee trigger by excessively expanding the point and fee definition will invariably cut off legitimate credit to our neediest borrowers.

B. HOEPA Protections:

- Refinancing a Loan Should Provide a Benefit to a Borrower. Existing loans should not be refinanced into a high cost mortgage loan unless doing so provides a benefit to a borrower. A national standard should allow regulators to establish objective safe harbors for determining when the benefit threshold is met.

- No Asset Based Lending. Evaluating a borrower's ability to repay a loan is fundamental to a lender in underwriting a mortgage application. A lender has every incentive to ensure a loan is properly underwritten since the lender takes the risk of loss on a defaulting loan and, through agreements with investors, can be forced to repurchase a loan from the secondary market. A borrower's ability to repay a high cost loan should not be solely based on the collateral value of the property.
- Assignee Liability. MBA supports the maintenance of the existing assignee liability regime provided in the Truth in Lending Act (TILA) and HOEPA.

C. Consumer Protections for All Loans:

- Prepayment Penalties Should Be Limited to Three Years. Prepayment penalties reflect an agreement between the lender and borrower whereby the borrower agrees to stay in a mortgage for a period of time in exchange for a lower rate or a significant reduction in fees. If a prepayment penalty is offered, it should be limited to three years and clearly disclosed to the borrower. The borrower should also be offered a loan without a prepayment penalty.
- Yield Spread Premiums Are a Valuable Financing Option. A yield spread premium (YSP) is a very good mortgage financing option that allows borrowers to pay closing costs through the rate. The inability to use yield spread premiums could bar creditworthy borrowers from homeownership. Where RESPA requires it, MBA would support improved YSP disclosures.
- Borrowers Should be Given Choice to State Income. Stated income loans are important to certain borrowers, especially in the emerging markets, because documenting their income in connection with a mortgage application can be difficult. Further, interested borrowers should be given the option of choosing a stated income loan versus a fully documented income loan if the borrower so chooses and if the lender has disclosed any cost difference.
- Home Improvement Contracts. Lenders should disburse loan proceeds to the borrower or jointly to the borrower and the contractor, or through a third-party escrow agent. Lenders must not disburse loan proceeds until the payment is approved in writing by the borrower, the contractor has signed a certificate of completion or the contract, and the property has been made available to the lender for inspection.

D. Standards for All Loans:

- Right to Cure. A national standard should permit lenders reasonable time to "cure" any unintended errors in the mortgage transaction without incurring any further or punitive liability.
- Accurate Appraisals. When formal valuation methods are required, lenders must evaluate properties through real estate appraisal professionals and/or through automated valuation models. Participants to the transaction must be careful not

to either pressure or be pressured. Lenders must ensure that the appraiser is licensed as required by law and make a good faith effort to ensure the appraiser is in good standing.

Finally, while any increases in delinquencies and foreclosures are an important concern, prohibition of particular products is not a solution – because they are not the cause. Many borrowers have used a range of products effectively to realize their dream of homeownership and otherwise satisfy the financial demands that we all face.

Conclusion

MBA has been long committed to fighting predatory lending and we would welcome the opportunity to work with members of Congress and staff to develop policies that weed out bad actors and allow the mortgage industry to continue to serve borrowers. Financial literacy, mortgage simplification and a uniform national standard are steps Congress can take to address abusive lending.

MBA wants to underscore the importance of innovation in making credit opportunities available to consumers. The products and financing tools are not predatory – they help borrowers get into homes. MBA believes that borrower choice should be protected and that consumers are in the best position to make good choices for themselves. The imposition of a suitability standard risks undermining our hard won gains in the areas of homeownership and reaching underserved borrowers. It will take away consumer choice as well as access to and affordability of mortgage credit. It will lead to counterproductive results – hurting the very borrowers it's intended to help.

Lenders and consumers alike have every incentive to keep borrowers in homes. Foreclosure is a loss for everyone. Currently, foreclosures are within normal ranges and are caused in large measure by life events like job loss, divorce and illness. Lenders work very hard to offset foreclosure and work with delinquent borrowers to try to keep them in their homes.

MBA looks forward to continuing to work with this Committee and the whole Congress to address challenges in the housing market and we stand ready to assist you however we can.

Thank you.

SPECIAL REPORT

MBA Policy Paper Series
Policy Paper 2007-1

Suitability — Don't Turn Back the Clock on Fair Lending and Homeownership Gains

MORTGAGE BANKERS ASSOCIATION®
Investing in communities

Overview

This policy paper, published by the Mortgage Bankers Association (MBA),[1] explains why the imposition of a "suitability standard" on the mortgage lending industry risks unintended, negative consequences for consumers that would turn back the clock on hard won fair lending and homeownership gains. The policy paper concludes that Congress should resist pressure to enact a suitability standard for the mortgage lending industry and, instead, should turn its attention to the creation of a uniform national lending standard, to improving financial literacy, to simplifying disclosures to consumers in the mortgage process, and to establishing clear, objective restrictions to stop lending abuses without impeding the market's vitality and its ability to innovate to benefit consumers.

1 The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 3,000 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web Site: www.mortgagebankers.org.

Executive Summary

The most recent data provided by the mortgage lending industry under the Home Mortgage Disclosure Act (HMDA) on loans made in 2004 and 2005 demonstrate the greatest and widest availability of mortgage finance in our nation's history, which in turn has made possible record homeownership rates. The data show that borrowers in virtually every area of the nation, of every race and ethnicity, and at every income level receive an unparalleled array of credit opportunities.

Over the last fifteen years, the confluence of objective mortgage lending criteria, automated underwriting, risk-based pricing, a robust secondary market and nonprime lending are all responsible for the increased availability and affordability of mortgage credit and homeownership, with the greatest gains achieved for minority and first-time homeowners.

These achievements have occurred against a backdrop of hard won fair lending and anti-redlining laws. Under the Fair Housing Act and the Equal Credit Opportunity Act (ECOA), lenders may not deny mortgage credit to borrowers because of their race, gender, religion, national origin and membership in other protected classes. The Community Reinvestment Act (CRA) and the Home Mortgage Disclosure Act (HMDA) seek to stem redlining of under served areas and broaden the availability of credit to borrowers who have not had access to the credit markets.

In light of the mortgage lending industry's achievements in democratizing credit, the debate no longer concerns whether credit is sufficiently available to borrowers. Rather, the debate now has turned to whether the loans particular borrowers receive are in their best financial interests. Because of claims of lending abuses and foreclosures, some consumer advocacy organizations have recently suggested that a "suitability standard" should be imposed on the mortgage lending industry. These advocacy organizations point out that a "suitability standard" applies to the securities industry and that experience should serve as a model for the mortgage lending industry.

While a specific proposal for a suitability standard for the mortgage industry is not yet fully formed, a variety of approaches have been suggested. Most would simultaneously require more rigid, prescribed underwriting standards, a duty of fair dealing at the inception of the loan, a subjective evaluation by the lender whether a product is best suited for that borrower, the establishment of a fiduciary obligation by the lender to the borrower and a private right of action to redress any violations. Some suggest that a regulator be empowered to specify the parameters of the requirement.

However, if rigid, prescribed underwriting standards were imposed, some borrowers will be unnecessarily denied needed credit. If a subjective suitability standard is imposed, a lender facing a mortgage applicant who is a member of a protected class and for whom a loan product may be "unsuitable" might deny the borrower credit to conform to the suitability requirement and, at the same time, violate the letter and spirit of fair lending and community investment requirements. If credit is extended, the lender risks violating the suitability requirement. Even if the facts suggest that a lender is in compliance with both fair lending rules and a suitability requirement, borrowers who go into default are likely to claim that the loan was "unsuitable."

Faced with contradictory legal requirements, some lenders and secondary market participants will understandably be reluctant to expose themselves to severe legal and reputational risks — lessening competition, rationing credit and increasing prices. Other lenders and secondary market participants, who choose to remain in the market, may be expected to increase their prices to reflect the costs resulting from increased risks including the risk that their collateral (the property securing the loan), will not be available to satisfy the debt because of suitability claims. Other compliance costs, including systems and training costs, will increase prices further for consumers.

A suitability standard would not provide benefits to consumers that outweigh these risks and costs to consumers, lenders and other market participants. Suitability attempts to control the product choices of borrowers to prevent defaults. However, the primary reasons for mortgage defaults are "life events," including job losses and family crises, not product choices. Furthermore, there is no public or private concensus on what is a socially optimal level of foreclosure against which the success of a policy choice can be objectively measured.

The securities industry is not analogous to the mortgage lending industry and imposition of a suitability standard on the mortgage lending industry is not appropriate. The policy imperatives of the two industries differ and so do their business models. The fair lending and community investment imperatives apply only to the mortgage lending industry.

Securities broker-dealers function as intermediaries between their customer and the market to invest their customers' money; broker-dealers hold themselves out as investment consultants. Mortgage lenders, on the other hand, represent their companies and investors whose money they put at risk to make loans to borrowers; they do not function as agents or fiduciaries and they do not hold themselves out as such to borrowers. Consumers select their securities advisor on a long-term basis, but regularly shop among lenders when seeking a mortgage.

Lenders can and do offer valuable information to consumers. Lenders help consumers understand what mortgage products are available and for what mortgages they may qualify. For this reason, it pays for consumers to see lenders early in the home buying process not only to determine what property they can afford, but also to consider their financing choices in relation to their particular situations, including their incomes, credit and plans to stay in their homes. Nevertheless, lenders cannot serve as agents and fiduciaries for borrowers as well as for their companies.

It is not clear that the suitability standard is working well in the securities industry. In fact, NASD[2] has expressed concern about the magnitude of claims brought against brokers based upon suitability.

Despite the wide range of market innovations, some borrowers have obtained loans with terms that negatively impact their ability to repay. The fundamental goal that borrowers only obtain loans they can repay is shared by consumers, advocacy organizations, regulators and mortgage lenders alike. For this reason, the mortgage lending industry has a great stake in striving, along with advocacy organizations, legislators and regulators, to make the lending process as understandable and abuse-free as possible and more work is needed toward this goal. However, imposing a suitability standard is not an appropriate solution and would run the risk of turning back the clock on innovations that have greatly expanded home ownership opportunities.

Congress, therefore, should resist pressure to enact a suitability standard which would harm consumers. Retaining the current "arms length" model in the mortgage lending industry works best. Rather than upsetting this model, Congress, federal regulators, industry and consumer organizations should turn their attention to working to create a uniform national lending standard, improving financial literacy and licensing, simplifying the mortgage process, streamlining disclosures, and establishing clear, objective restrictions to stop lending abuses without destroying the market's ability to innovate for the benefit of consumers.

2 Previously known as the National Association of Securities Dealers, Inc., it is now known only as "NASD."

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Suitability — Don't Turn Back the Clock on Fair Lending and Homeownership Gains

Introduction

Predatory lending abuses have been a major public policy concern at least since the mid-1990s. Congress enacted the Homeownership and Equity Protection Act (HOEPA) in 1994 and several states enacted laws to address this issue beginning with North Carolina in 1999. There are now 30 diverse state laws and 17 local laws on this subject.

During 2006, however, some consumer advocacy organizations, expressing the view that existing laws and regulations offer insufficient protection to consumers, began focusing their efforts on the possibility of imposing a suitability standard on the mortgage lending industry.[3] These advocacy organizations assert that lenders should be assigned an additional affirmative duty of determining the suitability of mortgage loans for prospective borrowers.[4] Their rationale is that beyond the insufficiency of current protections there is a persistent information asymmetry between lender and borrower concerning mortgage products. They assert that this point necessitates assigning the lender a fiduciary responsibility to serve the borrower. Asserting that suitability works in the securities industry, these advocacy organizations contend that it could also be applied to the mortgage lending industry.

While a specific proposal for suitability is not yet fully formed, a variety of approaches have been

3 See, e.g., *Calculated Risk: Assessing Non-Traditional Mortgage Products: Hearing Before the S. Subcommittee On Housing & Transportation, S. Comm. on Banking, Housing & Urban Affairs*, 109th Cong. (Sept. 20, 2006) (statement of Michael D. Calhoun on behalf of the Center for Responsible Lending); Remarks of Allen Fishbein at the Women in Housing and Finance Conference (Nov. 29, 2006).

4 See, e.g., Kathleen C. Engel and Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255 (May 2006); Daniel S. Ehrenberg, *If the Loan Doesn't Fit, Don't Take It: Applying the Suitability Doctrine to the Mortgage Industry to Eliminate Predatory Lending*, 10-WTR J. Affordable Housing and Community Dev. L. 117 (Winter 2001).

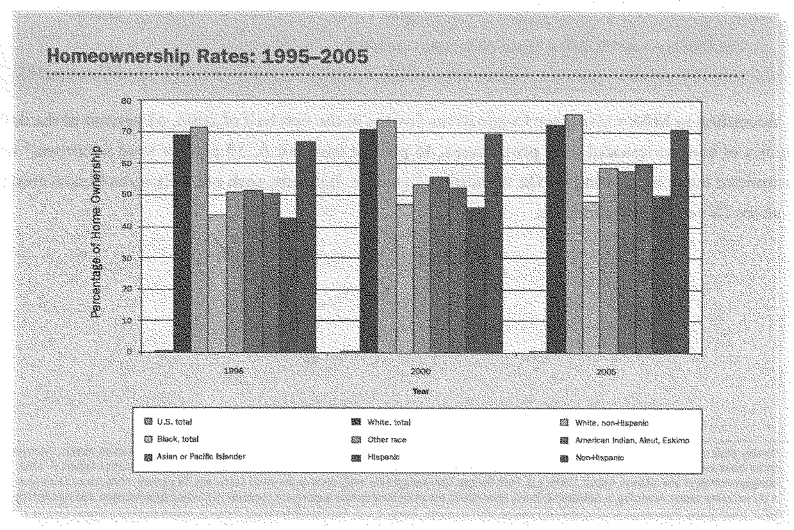
suggested. Most would simultaneously require more rigid underwriting, a duty of fair dealing at the inception of the loan, a subjective evaluation by the lender whether a product is best for that borrower, the establishment of a fiduciary obligation by the lender to the borrower, and a private right of action to redress any violations.

The following analysis explores these ideas and concludes that current proposals for imposition of a suitability standard on the mortgage lending industry risk unintended, negative consequences for consumers.

Today's Mortgage Market

The most recent data provided by the mortgage lending industry under the Home Mortgage Disclosure Act (HMDA) on loans made in 2004 and 2005 demonstrate the greatest and widest availability of mortgage finance in our nation's history, which in turn has made possible record homeownership rates. The data show that borrowers in virtually every area of the nation, of every race and ethnicity, and at every income level receive an unparalleled array of credit opportunities.

Homeownership is near its highest level in history. Homeownership rates rose roughly 3.5 percentage points in the U.S. between 1989 and 2001. Looking at recent years, in 2001, the overall homeownership rate was 67.8 percent. In 2005, it was 68.9 percent. For African-Americans, the rate in 2001 was 47.7 percent, and in 2005 it grew to 48.2 percent (although it was 49.1 percent in 2004). For Hispanics, the rate in 2001 was 47.3 percent and in 2005 it was 49.5 percent.



As a result of these increases in homeownership, across all demographics, Americans are building tremendous wealth by building equity through their monthly payments and through the impressive rate of home price appreciation we have seen in recent years. According to the Federal Reserve's Flow of Funds data, the value of residential real estate assets owned by households has increased from $10.3 trillion in 1999 to $22.4 trillion as of the first quarter of 2006, and aggregate homeowners' equity now exceeds $10 trillion. According to the Fed's 2004 Survey of Consumer Finances, the median net worth for homeowners was $184,000. For renters, it was $4,000.

More than a third of all homeowners, approximately 34 percent, own their home free and clear. Of the remaining two-thirds of homeowners who do have mortgages, three-quarters of these homeowners, or half of all homeowners, have fixed rate mortgages. Only one quarter of these borrowers, or about a sixth of all homeowners, have adjustable rate mortgages (ARMs).

Homeowning Household Distribution
By Mortgage Type

Household Mortgage Type	Percent	Percent of Those with a Mortgage
No Mortgage	**34.6**	
Fixed Rate	49.2	75.2
Adjustable Rate	**16.2**	**24.8**
Jumbo	3.9	6.0
Conforming	12.3	18.8
Total	**100.0**	**100.0**

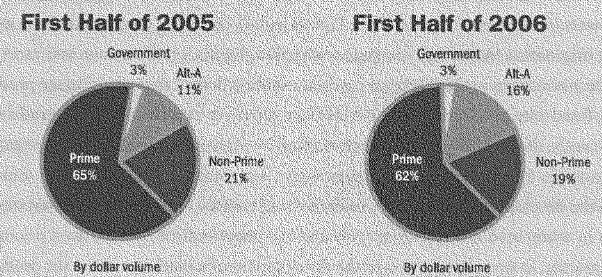
Source: American Housing Survey; Mortgage Bankers Association

According to MBA's Mortgage Originations Survey, in the first half of 2006, 62 percent of the dollar volumes of loans originated were prime loans, 16 percent were Alt A, 19 percent were nonprime,[5] with government loans accounting for the remaining 3 percent. Recently, cash out refinances have accounted for about 75 percent of refinances.

5 Notably, while nontraditional products have offered borrowers a variety of options, many of these products are not prevalent in the nonprime market. Payment-option loans are typically not available in the nonprime sector. In fact, according to Fitch, no nonprime loans carried a negative amortization feature in 2005. *Mortgage Principles and Interest*, August, 2006, p.6, Fitch Ratings. The interest only, or IO, share in the prime sector was 44 percent, while it was 25 percent in the nonprime sector. According to Standard & Poors, nonprime IO borrowers tend to have larger loans, typically indicating higher incomes, and significantly better credit scores than nonprime borrowers who choose other products. *Trends In U.S. Residential Mortgage Products: Subprime Sector Second Quarter 2006*, Standard & Poors, 2006.

Reports by MBA members and other data reviewed by MBA indicate that interest-only and payment-option mortgage borrowers generally have higher credit scores and lower loan-to-value (LTV) ratios. These products tend to most prevalent in higher cost areas of the country such as California.

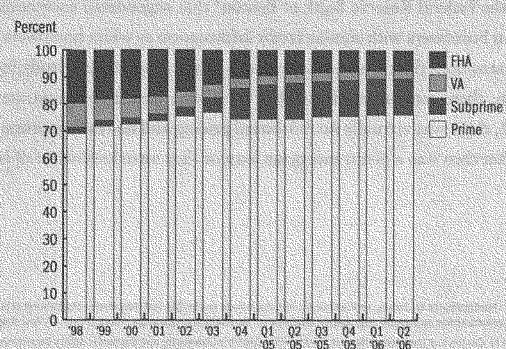
Mortgage Originations by Loan Type



Source: MBA's Mortgage Origination Survey

Estimates from MBA's National Delinquency Survey indicate that the number of nonprime loans has increased more than 6.5 times over the last five years. (Q3 2001 to Q3 2006). Contrary to the perceptions of some, based on first half 2006 data, nearly half the borrowers, or 45 percent, utilizing nonprime loans do so to buy homes. One in four of these purchases was by first-time homebuyers. Also, notably, over the last several years the average difference between the interest rates of prime loans and nonprime loans has decreased markedly from three to two percent.

Outstanding Loans by Loan Type: 1998–Present



Source: MBA's National Delinquency Survey

Objective Lending Criteria, Automation and Risk-based Pricing Extending Credit to More Borrowers

The confluence of several factors has contributed to the growth in credit opportunities for prime and nonprime borrowers over the last 15 years. These factors include increased competition from an unparalleled number of loan originators including mortgage companies, banks, credit unions and mortgage brokers. They also include innovations in the mortgage market, resulting in the range of mortgage products available today including fixed-rate products and adjustable rate products as well as the "nontraditional."[6]

Most importantly, the past 15 years has been marked by dramatic changes in the mortgage origination process made possible by technology. Computerization has enabled a much greater understanding of default risk and the development of objective underwriting criteria. It has also permitted the embodiment of these criteria in automated underwriting tools and the improvement of risk-based pricing.

Risk-based pricing, in turn, has permitted the development of a market to serve the needs of nonprime borrowers "who have difficulty in meeting the underwriting criteria of 'prime' lenders because of blemished credit histories or other aspects of their profile."[7]

Since the rise of the nonprime market, home lending to minority borrowers, particularly African-American and Hispanic borrowers, has risen significantly.[8] Notably, the use of automated systems in the prime and nonprime markets has not only extended credit but made its availability "color blind."

Fifteen years ago, in 1992, when a consumer went to a loan officer, the loan officer considered a credit report, a property appraisal, employment information, asset information and similar risk related information to determine whether a borrower qualified for a mortgage loan. Notwithstanding that the Fair Housing Act and ECOA pertained, there is evidence that some loan personnel, sometimes unconsciously, denied credit to borrowers from protected classes more frequently than they denied credit to majority borrowers, even though the borrowers had similar risk profiles.

A 1992 study by the Federal Reserve Bank of Boston[9] that engendered enormous controversy found that African-American borrowers with similar credit information as white borrowers were more likely to be denied mortgage loans than their white counterparts. While a subseuqent study by the FDIC reversed the study's conclusion, there remains evidence that there may have been disparate treatment by loan officers. Also, in 1992, there was virtually no risk-based pricing and no real nonprime market. Borrowers either qualified for what then was a prime mortgage loan or they were locked out of homeownership and remained renters.

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6 Under the Federal Regulators' Nontraditional Guidance, nontraditional products include mortgages that may involve the deferral of principal and/or interest, including interest-only and payment-option mortgages. *Interagency Guidance on Nontraditional Mortgage Product Risks*, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

7 Remarks by Governor Edward M. Gramlich at the Federal Reserve Bank of Philadelphia's Community and Consumer Affairs Department Conference on Predatory Lending, Philadelphia, Pennsylvania (December 6, 2000).

8 See Department of Justice, Fair Lending Enforcement Program (Jan. 2001) stating that home mortgage loans to African-American and Hispanic borrowers increased by 72 percent and 87 percent, respectively, in the years 1993 to 1998. Conventional mortgages to minorities also increased significantly during this time. Gramlich, supra note 7.

9 Alicia H. Munnell, Lynn E. Browne, James McEneaney, and Geoffrey M.B. Tootell, *Mortgage Lending in Boston: Interpreting HMDA Data*, Federal Reserve Bank of Boston, Working Paper WP-92-7, October 1992.

Beginning in the mid-1990s, credit scoring and sharper underwriting tools were developed using computer technology. Statistical evaluations of defaults and other risks permitted validation of these new systems.

Today, loans are priced based on risk — borrowers pay a rate that conforms to the risk presented by their credit, the amount of down payment or equity they bring to the transaction and other relevant risk related factors.

While a lender and its employees are called upon to exercise judgment in the mortgage process, including in instances where a borrower's application is referred from an automated underwriting system, there is a greater degree of objectivity in the mortgage process than ever previously existed. The increase in objectivity and the advent of risk based pricing has coincided with a reduction in denial rates of African-American loan applicants.

Since the 1990s, the denial rates of African-American loan applicants, though still greater than white borrowers, have declined considerably. In 1992, the denial rate for conventional home purchase loans for African-American borrowers was 36 percent and in 2004 it was 24.7 percent. While there has been some increase in the institutions covered by HMDA over these years, the number of applications nearly quadrupled over this period.[10]

Although all homeownership has increased since the 1990s, the percentage increase in African-American homeownership has been greater than among whites and the national average. The African-American homeownership rate has increased almost six percentage points since 1994, while the overall rate has increased nearly five percentage points. (Note that both rates fell from 2004 to 2005.)

The chart on page 12 illustrates increases in the homeownership rate during the period when objective lending criteria, automated systems and risk-based pricing were introduced.

Fair Lending and Antipredatory Laws

All of the mortgage lending industry's achievements in bringing credit to borrowers have occurred against a backdrop of legal requirements. These requirements seek to assure the availability of credit to all borrowers without regard to race, religion, gender, age or membership in other protected classes and to stem redlining of under served areas and broaden the availability of credit to borrowers who have not had access to the credit markets.

The Fair Housing Act[11] makes it unlawful for any lender to discriminate in its "residential real estate-related" activities against any person because of race, color, religion, gender, handicap, familial status, or national origin.

10 1992 and 2004 HMDA data.

11 Title VIII of the Civil Rights Act of 1968, as amended, 42 U.S.C. §§ 3601 et seq.

The Equal Credit Opportunity Act (ECOA) prohibits discrimination with respect to any aspect of a credit transaction on the basis of race, color, religion, national origin, gender, marital status, age, receipt of income from public assistance programs, and good faith exercise of any rights under the Consumer Credit Protection Act.[12] ECOA applies to all stages of the credit transaction, from application to closing.

The Community Reinvestment Act of 1977 (CRA)[13] requires that each federal financial supervisory agency assess the record of each covered depository institution in helping to meet the credit needs of its entire community, including low- and moderate-income (LMI) neighborhoods, consistent with safe and sound operations, and that such record be taken into account when deciding whether to approve an application by the institution for a deposit facility. CRA does not require any specific percentage or lending ratio, but instead encourages institutions to lend in LMI neighborhoods in addition to higher-income neighborhoods.

HMDA[14] is a disclosure law. While it does not prohibit any specific activity of lenders, it requires the public reporting of lenders' loan activities for the purposes of increasing investment in metropolitan areas and enforcing the fair housing laws. Under HMDA, financial institutions must report data regarding loan originations, applications, and loan purchases, as well as requests under a pre-approval program if the pre-approval request is denied or results in the origination of a home purchase loan. HMDA requires lenders to report the ethnicity, race, gender, and gross income of mortgage applicants and borrowers, information regarding the pricing of higher cost loans, whether the loan is subject to HOEPA, and the type of purchaser for mortgage loans that they sell.

Advocacy for a Suitability Standard

In light of the mortgage lending industry's achievements in democratizing credit, the debate no longer concerns whether credit is sufficiently available to borrowers. Rather, the debate now has turned to whether the loans particular borrowers receive are in their best financial interests. Most recently, because of claims of lending abuses and foreclosures, some consumer advocacy organizations have recently suggested that a "suitability standard" should be imposed on the mortgage lending industry, making the industry responsible for assuring the suitability of products for borrowers. These advocacy organizations point out that a "suitability standard" applies to the securities industry and that experience should serve as a model for the mortgage lending industry.

While a specific proposal for suitability is not yet fully formed, there are a variety of approaches. Most would simultaneously require more rigid, prescribed underwriting, a duty of fair dealing at the inception of the loan, a subjective evaluation by the lender whether a product is best for that borrower, the establishment of a fiduciary obligation by the lender to the borrower and a private judicial remedy for violations. Some suggest that a regulator be empowered to specify the parameters of the requirement.[15]

Some of the proposals in the nature of rigid, uniformly prescribed underwriting standards to assure a

12 15 U.S.C. §§ 1691 et seq.
13 12 U.S.C. §§ 2901 et seq.
14 12 U.S.C. §§ 2801 et seq.
15 See, e.g., Engel & McCoy, supra note 4.

borrower's ability to repay might require a rigid minimum debt-to-income ratio or similar standard that would require that a lender may not extend a loan to the borrower unless the borrower meets the test. Another suggestion would require that all adjustable rate mortgages be underwritten to a fully indexed rate. Still others would require that the borrower gain a "net tangible benefit" from the loan transaction.

Subjective standards are proposed to include an obligation on the part of the lender to assure that a loan is the "best product to meet the borrower's needs." Many advocacy organizations have also urged that a mortgage lender should be legally required to act as a fiduciary with respect to borrowers. Most recently, Ohio considered and ultimately rejected a proposal to impose a fiduciary duty on lenders and mortgage brokers.[16]

Similarly, and often as a substitute for a broader fiduciary duty, a handful of states have enacted legislation that imposes on lenders and/or mortgage brokers an explicit duty of good faith and fair dealing.[17] In August 2006, the National Consumer Law Center (NCLC) recommended the imposition of a "duty of good faith and fair dealing" to address "irresponsible underwriting, unsuitable loans, and steering" in the nonprime[18] market.[19] Likewise, in September 2006, advocacy organizations suggested that Congress adopt a duty of good faith and fair dealing applicable to the "non-traditional, hybrid adjustable rate and nonprime market."[20] In both proposals, the duty would include a vaguely worded suitability requirement, specify underwriting standards for determining a borrower's ability to repay a loan based on the "maximum payments" possible under a loan, and prohibit steering.

In addition, effective January 1, 2007, the Ohio mortgage broker licensing and usury law requires lenders and mortgage brokers to make "reasonable efforts" to obtain financing that is "advantageous" to the borrower in terms of rates, charges and repayment terms without providing any guidance as to what standards apply or what constitutes compliance.[21]

Advocacy organizations also have indicated that they would want to require that the lender should, as a matter of law, have a fiduciary responsibility to determine, based on largely subjective criteria, that a particular loan product is properly matched to the needs of a particular borrower. The lender's judgment of suitability would be reviewable in the courts through a private right of action. This approach is described as modeled on the responsibilities that broker-dealers have in the securities industry.

16 See, e.g., § 1322.081 of both the House and Senate versions of Ohio Senate Bill 185. The Senate version states that a broker and lender "shall be a fiduciary of the buyer and shall use their best efforts to further the interest of the buyer." Ohio S.B. 185, 126th Gen. Ass. (2006).

17 See N.C. Gen. Stat. § 53-243.11(8); Ohio Rev. Code § 1322.081.

18 Nonprime lending can perhaps be most simply described as "lending with elevated credit risk." Based on a number of carefully weighted factors, including, but not limited to, credit score, loan-to-value ratio, income and assets, and attributes of the property itself, nonprime loans are given to loan applicants who have a weaker credit history or demonstrate less of a capacity to repay the loan than borrowers qualifying for prime credit. The basic principle is that borrowers who do not qualify for prime loans present a greater risk of default, which justifies lenders charging higher rates and fees to compensate for the added risk associated with such loans.

19 *Home Equity Lending Market: Hearing Before the Board of Governors of the Federal Reserve System*, Docket No. OP-1253 (Aug. 15, 2006) (comments of National Consumer Law Center).

20 *Calculated Risk: Assessing Non-Traditional Mortgage Products: Hearing Before the Senate Subcommittee On Housing & Transportation, Senate Committee on Banking, Housing & Urban Affairs*, 109th Cong (Sept 20, 2006) (statement of Allen J. Fishbein, on behalf of Consumer Federation of America and National Consumer Law Center).

21 Ohio Rev. Code § 1322.081.

Proposals With Unintended Negative Consequences

Rigid, prescribed underwriting standards, though objective, will result in considerably more borrowers being denied credit than need to be; in fact, such standards are not needed to assure that a borrower will repay a loan.

For example, a rigid debt-to-income ratio of 45 percent might work to qualify some borrowers but it will also result in the denial of credit to those who can reasonably expect higher income in the near future. The promising medical student or law clerk may be denied a loan notwithstanding his or her future earning capability and a sound credit decision that could acknowledge this fact.

Also, if a loan must be underwritten to a fully indexed rate, even though a nonprime borrower has equity in the home and is certain to refinance prior to any adjustment, the option of lower payments under such a loan will be denied to a borrower notwithstanding that the loan may be a sound option while the borrower repairs his or her credit. It is important to note that in many cases the alternative to a flexibly underwritten ARM may not be a fixed rate loan, but rather no loan at all. The borrower simply may not qualify for a fixed rate loan to finance the home because the payments are initially higher.

Although the concept of "good faith and fair dealing" can apply during the life of the loan, imposing the requirement on the origination of the loan creates new and undefined risks. The Uniform Commercial Code (UCC) incorporates by reference the duty of good faith defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing," into each contract with respect to "its performance and enforcement."[22] As explained by the NCLC, the duty of good faith is imposed on parties to an existing contract "to prohibit improper behavior in the performance and enforcement" of that contract.[23] The treatise notes, with citations to numerous lending cases, however, that the duty does not arise until the parties have reached an agreement and does not extend to contract negotiations.[24]

Implementing the "good faith and fair dealing" standard at the front end of a loan transaction as a suitability and anti-steering requirement would markedly change the relationship between the debtor and the creditor and create a large and undefined contingent liability. All of the lender's sales efforts would be judged by this subjective standard and there is no case history setting the limits of the lender's responsibility. Consequently, a borrower may successfully challenge nearly every term of a loan using this formulation.

22 UCC §§ 1-201(20), 1-304.

23 National Consumer Law Center, The Cost of Credit: Regulation and Legal Challenges, § 12.8 (3rd ed. & Supp.).

24 Id. at n.652.

Moreover, by making such open-ended claims justiciable as private rights of action, the proposal assures that there will in fact be extraordinary claims and costs to the lender that will be ultimately priced into all loans and thereby passed on to all borrowers. While it is hard to quantify what these increased costs will be, considering that there were more than 10 million loan transactions in 2005,[25] one can anticipate claims in the billions of dollars. Additionally, the loss of competitors that might understandably shy away from such liability will reduce competition and increase consumer costs and must be computed in the costs of such a standard.

Notably, while advocacy organizations suggest that the mortgage lending industry borrow suitability from the securities industry, there is no suggestion by any that mandatory arbitration, which is employed in the securities industry, should be imported into the mortgage market in lieu of judicial remedies.

Subjective Suitability Requirements Risk Undermining Fair Lending, Community Investment and Homeownership Gains

While certainly not intended to promote or authorize discrimination or reignite redlining, the injection of subjective underwriting standards would conflict with and potentially threaten fair lending, community reinvestment and homeownership gains.

Were a suitability standard imposed requiring "good faith and fair dealing" or that "the best product be provided to the borrower," lenders may be obligated to deny or discourage members of protected classes, such as African-Americans and the elderly, from particular types of mortgages such as those with adjustable rates. Such a denial of credit may violate existing laws and would certainly undermine fair lending gains. On the other hand, if the lender chose to ignore the standard and offer credit in a nondiscriminatory manner as the law demands, the lender may risk an enforcement action or a lawsuit for violating the suitability standard.

As an illustration, consider the following. A typical tool used to measure fair lending compliance is "matched pair testing," a process by which two testers, one in a protected class and the other of different race, gender or age but with similar risk characteristics, seek to obtain a mortgage loan. If the tester from a protected class is denied or even given less encouragement than the other tester, this is offered as evidence that the lender is discriminating against the tester's protected class.

The U.S. Department of Housing and Urban Development (HUD) funds fair lending advocacy groups to conduct such tests and uses the results to promote settlements in which the lender is encouraged to make a monetary payment and agree to adopt training and other policies to enhance availability of credit to protected classes. There is not a great deal of legal precision around these proceedings, but rather the lender is put in the position of having to decide to fight discrimination charges that may not be accurate, but would be damaging to the lender's reputation, or to settle.

25 2005 Home Mortgage Disclosure Act data cited in Robert P. Avery and Glenn Canner, "New Information Reported under HMDA and Its Application to Fair Lending Enforcement," Federal Reserve Bulletin (2005).

Applying these tests to a lender's operations under the suitability requirement, a young white tester may gain access to an ARM that an older African-American individual was denied or discouraged from by virtue of a suitability requirement. Notwithstanding, such denial may result in a prima facie claim of discriminatory treatment under the Fair Housing Act.

As indicated, the potential for legal challenges under a suitability standard are considerable. While challenges to "suitability" will certainly occur when a loan goes bad or becomes uncomfortable, claims of discrimination can be expected whenever a borrower belonging to a protected class is denied or is discouraged from applying for a loan. Additionally, the potential for reputational risk based on claims of discrimination or predatory lending is enormous.

To avoid legal or reputational difficulties, some lenders understandably will restrict the amount of credit they make available in under served markets. The result would be to increase the price and thereby restrict the availability of credit, turning back the clock on the gains brought by CRA, HMDA, and the market innovations which have been developed by the mortgage lending industry.[26]

As Federal Reserve staff pointed out in the report accompanying the release of the 2004 HMDA data, even the misuse of HMDA data on a lender's pricing of loans risks reputational harm and disinvestment.[27] These concerns greatly increase in this context where lenders will face both reputational risks and the risks of suitability and fair lending suits at the same time.

It is noteworthy that survey data indicates that an intrusion by lenders into the borrower's personal decisions is unwelcome by the borrower whom a suitability standard would be designed to protect. One recent study found that 88 percent of respondents would prefer to "decide for themselves whether or not a mortgage product is right for them, rather than leaving that responsibility to the mortgage lender."[28]

Also notably, borrowers subject to a pilot program in the City of Chicago that imposes mandatory financial counseling only for borrowers in specific ZIP codes have filed a law suit alleging that the program amounts to "state-sanctioned redlining."[29]

To be clear, the lending industry does not support government efforts to deny credit to any borrowers whatsoever. However, if Congress or a state legislature decides that certain types of loans are unsuitable for particular classes of borrowers, it should provide clear prohibitions that do not require lenders to substitute their judgment for a borrower's. In addition, lenders acting pursuant to the legislative mandate should be granted immunity from legal challenge under fair lending or other laws as long as their actions are in compliance with the legislative directive.

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26 See, e.g., *Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Hearing Before the Subcommittee on Housing and Community Opportunity, Subcommittee on Financial Institutions and Consumer Credit,* 106th Cong. (Nov. 5, 2003) (statement of Micah S. Green on behalf of the Bond Market Association noting a quarter percentage point increase in lending rates as market participants withdrew from the market).

27 Robert P. Avery and Glenn Canner, *New Information Reported under HMDA and Its Application to Fair Lending Enforcement,* Federal Reserve Bulletin (2005) at 393.

28 See American Financial Services Association Press Release, *Borrowers, Not Lenders, Should Decide Appropriateness of Mortgage Products, Finds Survey,* (Nov. 20, 2006).

29 See Mary Umberger, *Home Buyer Counseling Challenged,* Chicago Tribune, Nov. 2, 2006.

A Suitablity Standard Is Not Worth the Risks of Limited Borrower Choices and Increased Borrower Cost

For those lenders who remain in the market, after the imposition of a suitability standard, the new risks to the lender and to the secondary market will increase compliance costs and consequently the costs of credit.

Several factors determine the particular mortgage interest rate that a particular borrower receives. The first and most important is the 10-year Treasury note rate,[30] which in large measure has become the benchmark for the 30-year fixed mortgage.[31] Mortgages typically trade at a spread above Treasury rates because the lender bears both the credit risk (the risk that a borrower may default) and prepayment risk (the risk to the investor that the borrower may refinance or move, thereby paying the loan off ahead of its stated maturity). Lenders incur expenses in originating a loan which may only be defrayed by pricing prepayment risk into the loan.

The second factor, therefore, in the mortgage price is the premium over the Treasury rate to account for a borrower's expected credit and prepayment risk. Nonprime borrowers tend to have both a greater level of credit risk, i.e., higher expected levels of delinquency and default as a result of their prior credit problems, and greater prepayment risk. The reason for the greater prepayment risk is that nonprime borrowers frequently refinance their loan if their credit improves and they qualify for a lower rate. Objective risk factors, including credit scores and other items from a borrower's credit report such as payment history on prior mortgages, loan-to-value ratios, debt-to-income ratios, and other underwriting variables, are powerful predictors both of a borrower's likelihood to pay on their loan and to prepay.

A third factor in the price is the amount of administrative and other expenses associated with the loan. Loan applications that take additional time for an originator to complete are more costly. Additionally, small loans are more expensive to originate because the fixed costs are spread over a smaller balance. Nonprime loans tend to be significantly smaller on average relative to prime loans. Compliance costs are also a key part of the administrative expenses associated with the loan. These costs include insurance and legal work, training employees and systems related costs.

Typically, the price of a loan is arrived at using a statistical model which may be embedded in an automated underwriting system (AUS). The use of automated underwriting for most borrowers allows lenders to concentrate their attention on helping borrowers with unique credit histories or other characteristics qualify for financing.

30 The 10-year Treasury rate reflects the risk-free credit of the United State government. The 10-year rate also cannot be called; investors can expect to receive the stated interest rate on their investment for the full 10 years.

31 In fact, lenders use a variety of indices to determine their cost of funds and to help price their loans, including the LIBOR/swap index.

If borrowers are in effect granted a new "suitability" defense to foreclosure actions by law, costs will increase and credit options will narrow. The ability to foreclose is an essential element of the mortgage cost, a factor that makes mortgage credit cheaper than almost any other form of credit because the lender has the security of the collateral real estate backing the loan.[32]

If the ability to realize on the lender's security interest is impaired, the lender will have to charge higher rates to the disadvantage of the vast majority of borrowers who pay their loans on time. The final factor in the determination of a borrower's mortgage rate depends on the borrower. Borrowers who aggressively shop among several lenders are likely to get a better rate than borrowers who visit only one lender or mortgage broker. These borrowers make the competitive marketplace work for them and help wring out any excesses in pricing through their efforts. There are more than 10,000 mortgage lenders competing for business in the American market.[33]

Assessing the impact of new requirements imposed by various state anti-predatory lending laws in 2004, the United States Government Accountability Office (GAO)[34] noted that state laws that included assignee liability provisions inflicted the negative, unintended consequence of discouraging legitimate market activity, restriction of availability of loans, and increase in costs of the loans that were available.[35] Specifically, the report noted that "if secondary market participants are not willing to risk having to assume liability for violations committed by originators, they may pull out of the market altogether, reducing the availability and increasing the costs of legitimate nonprime credit. Finally, if states' predatory lending laws have different terms and provisions regarding assignee responsibilities, the secondary market as a whole could become less efficient and liquid, further increasing rates on legitimate nonprime mortgages."[36]

32 Significant sums are lost by lenders when loans go into foreclosure. The estimated losses on... foreclosures range from 30 percent to 60 percent of the outstanding loan balance because of legal fees, foregone interest, and property expenses. See Karen Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, Federal Reserve Working Paper (2003).

33 Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data*, Federal Reserve Bulletin (2006) at A123. This report, accompanying the release of the HMDA data, points out that nearly 8,850 lenders are covered by the law and that this accounts for an estimated 80 percent of home lending nationwide. Additionally, mortgage brokers are not covered by HMDA.

34 Then known as the "General Accounting Office."

35 General Accounting Office Report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate at 84.

36 Id.

The Primary Reasons for Defaults Are Family and Economic Difficulties Not Product Choices

There is no evidence that product choices by borrowers are determinative of defaults or foreclosures. Different products have different default rates but the product choice does not cause the default. Data consistently demonstrate that delinquencies among all borrowers are a function of a variety of factors including, first and foremost, economic difficulties caused by job losses. According to Freddie Mac, based on a sample of loans in Workout Prospector,® 1999-2005, the following are the reasons for delinquency:

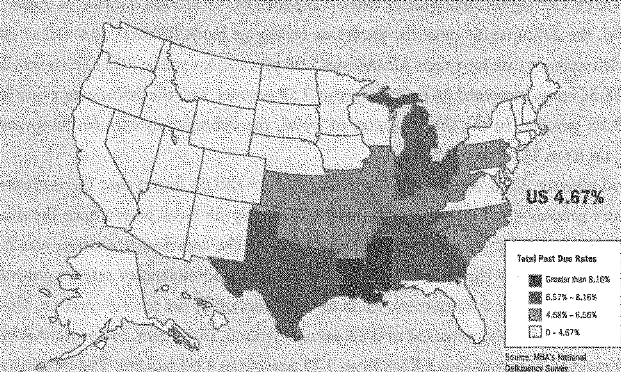
Reasons for Delinquency

Unemployment or curtailment of Income	41.5%
Illness or Death in Family	22.8%
Excessive Obligation	10.4%
Martial Difficulties	8.4%
Extreme Hardship	3.3%
Property Problem or Casualty Loss	2.1%
Inability to sell or rent property	1.6%
Employment Transfer or Military Service	0.9%
All Other Reasons	9.0%

Source: Freddie Mac

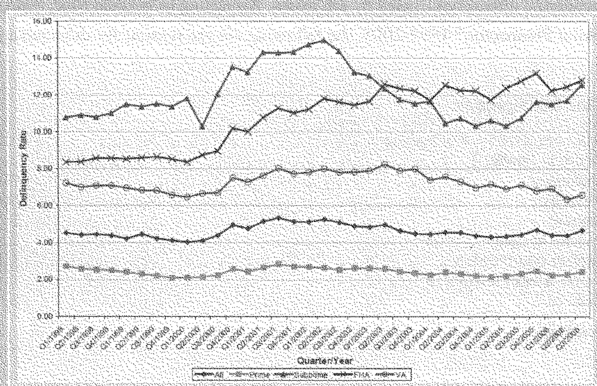
Variations in delinquencies from state-to-state reflect differences in the level of unemployment.

Total Loans Past Due Rates by State for Q3, 2006



Assertions that delinquency rates are at crisis levels and that a greater percentage of borrowers are losing their homes are not supported by data. In fact, delinquency and foreclosure rates, including among nonprime borrowers, have remained relatively low with some increases over the last year.

Total Delinquency Rate by Loan Type



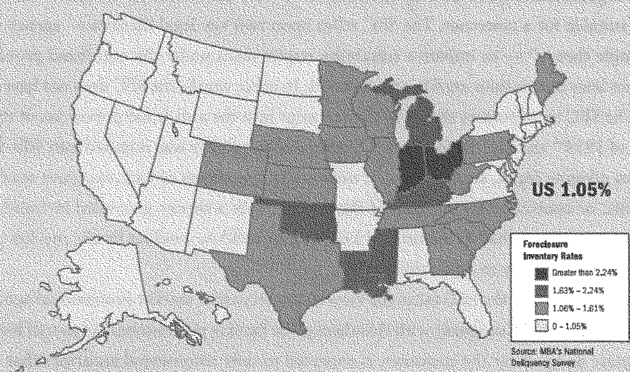
Source: MBA's National Delinquency Survey

All ARM loans had higher delinquency rates compared to the second quarter of 2006. In the third quarter of 2006, the delinquency rates for fixed rate mortgage loans (FRMs) were either unchanged or declined. The delinquency rate for prime ARMs was 3.06 percent, for prime FRM loans was 2.10 percent, for nonprime FRM loans increased 36 basis points to 9.59 percent, and the delinquency rate for nonprime ARMs was 13.22 percent. In the third quarter of 2006, the delinquency rate for nonprime loans was 12.56 percent, up from 11.70 percent.[37]

MBA's third quarter 2006 National Delinquency Survey (NDS) found that the percentage of loans in the foreclosure process was 1.05 percent, an increase of only six basis points from the second quarter of 2006, while the seasonally adjusted rate of loans entering the foreclosure process was 0.46 percent, three basis points higher than the previous quarter. The foreclosure inventory rate for subprime loans in the third quarter of 2006 was 3.86 percent, up from 3.56 percent in the second quarter. The foreclosure inventory rate for prime FRMs increased to 0.36 percent from 0.34 percent, for prime ARMs from 0.56 percent to 0.70 percent, for nonprime ARMs from 3.88 percent to 4.68 percent. The foreclosure inventory rate decreased for subprime FRM loans from 3.05 percent to 3.00 percent.

37 These figures are based on MBA data. MBA defines "delinquency" as having one or more payments overdue. The loans in foreclosure are approximately a third of these numbers, and borrowers actually losing their homes are approximately one-fourth of that group.

Foreclosure Inventory Rates by State for Q3, 2006



In its most recent data, MBA is seeing increases in delinquencies and foreclosures for nonprime loans, particularly nonprime ARMs. Because of efforts by the industry and the appetites of borrowers for credit, the share of outstanding loans that are nonprime has been increasing for the last several years. The higher average delinquency and foreclosure rates among these loans mean the overall statistics for total outstanding mortgages are unlikely to fall as low as in the past.

It is important to note that nonprime loans have always had higher delinquency and foreclosure rates and lenders factor in these risks when lending to nonprime borrowers. Given the fact that nonprime borrowers have weaker credit profiles, this is not surprising. Foreclosures also can be accelerated by slow housing markets that limit borrowers' ability to quickly sell in order to cover their losses. MBA data has indicated that over the last several quarters a number of factors, including the aging of the portfolio, increasing short-term interest rates and high energy prices, have been putting upward pressure on delinquency rates. However, healthy economic growth and vibrant labor markets have offset these pressures.

Nevertheless, for each borrower whose loan goes into default and is foreclosed, the experience is a traumatic one, and it is not surprising that counsel for such borrowers would assert every claim available to permit their clients to hold onto their homes. In this context, it is likely that claims of unsuitability will make their way onto the list of defenses advanced by borrowers to head off foreclosure. If the experience of the securities industry is a guide, whenever the market declines, claims of unsuitability of recommended investments spike.

The Suitability Standard in the Securities Industry

Neither the Securities Exchange Act of 1934 nor the U.S. Securities and Exchange Commission's (SEC) implementing regulations impose an express duty on market professionals to ensure that a securities transaction is suitable for a customer. The SEC relies upon two key legal theories — agency law and the so-called "shingle theory" — to impute a suitability requirement under the anti-fraud provisions of the federal securities laws to securities market professionals. In other words, the SEC does not have a suitability rule as such. The SEC incorporates the suitability concept into the anti-fraud provisions of the Securities Exchange Act of 1934[38] and SEC Rule 10b-5.[39] Essentially, suitability was imputed into 10b-5 along with other violations alleging fraud, such as false or misleading statements of fact, excessive markups, boiler room operations, or control or domination of the market.[40] As a theory grounded in fraud, there must be a showing of *scienter* — that is, intentional knowing or reckless conduct by the market professional — for a claim of unsuitability to be established.[41]

Under the agency theory, the SEC takes the view that a securities market professional acts as an agent on behalf of the customer.[42] Consistent with this theory, the market professional, as part of his or her duty of care and loyalty as agent for the customer, is expected to only recommend securities that are suitable to the customer's financial means and investing goals. The case law consistently supports this idea.[43]

The key factor in this theory is that an agency relationship results when a market professional *recommends* a transaction.[44] Also, the "shingle theory" postulates that the act of holding oneself out as a securities market professional implies that one will deal fairly with the investing public.[45] The very point of holding oneself out as someone who offers investment opinions on a fee basis is to cultivate a relationship with a client based on a high degree of trust and confidence, in return for the duty to act in the best interests of that client.[46] Because securities market professionals possess greater skill and knowledge about the securities markets when they recommend a securities transaction to customers, the customer reasonably relies on the professional's skill and knowledge in agreeing to engage in the recommended transaction. The market professional has a responsibility only to recommend transactions that are suitable for the customer.

The case law is consistent, however, in holding that where the securities market professional merely

38 15 U.S.C. § 78j (b).

39 See Clark v. John Lamula Customers, Inc. [Every registered broker-dealer must be a member of a registered national securities association unless it transacts only on a stock exchange of which it is a member. 15 U.S.C. § 78o(b) (8).]

40 Lewis D. Lowenfels and Alan R. Bromberg, Suitability in Securities Transactions, 54 Business Lawyer 1557, 1581 (August 1999).

41 See, e.g., Brown v. E.F. Hutton Group, Inc. 991 F.2d 1020, 1031 (2d Cir. 1993); McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir 1989) ("A successful cause of action under Section 10(b) or Rule 10b-5 requires that the plaintiff prove (1) a misstatement or omission (2) of a material fact (3) made with *scienter* (4) upon which the plaintiff relied (5) that proximately caused the plaintiff's loss."); Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 57, 61 (2d Cir. 1985).

42 Restatement (Second) of Agency § 387.

43 See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng, 901 F. 2d 1124, 1128 (D.C. Cir. 1990); Hanly v. S.E.C., 415 F.2d 589, 597 (2d Cir. 1969) ("a broker cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation, he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information.").

44 Unfortunately, while the NASD has made efforts to clarify the rules, there are not yet sufficient bright-line standards either in case law or in NASD, SEC, or other published guidance as to what constitutes a "recommendation," thus leaving the securities industry without certainty as to the situations in which the suitability rule applies.

45 See Kahn v. S.E.C., 297 F.2d 112, 115 (2d Cir. 1961) (Clark, J. concurring) (citing Loss, Securities Regulation 1490 (2d Ed. 1961)).

46 See, e.g., Arlene W. Hughes, 27 S.E.C. 629 (1948).

takes an order from a customer without additional action or input, there is nothing about that relationship that would create an expectation by the customer that the market professional is appealing to a relationship of trust and confidence or from a position of superior skill or knowledge about the investment decision to be made.[47] The customer has already made his or her own decision regarding the transaction. No special, heightened duties are owed in this circumstance. Rather, the professional's responsibilities commence when the order is placed and ends when the transaction is complete.[48]

The Securities Industry is Not Analogous to the Mortgage Lending Industry

While the importation of the suitability standard from the securities industry to the lending industry may at first seem reasonable, the industries are not analogous and such a standard is not appropriate for the mortgage lending industry. There are substantive differences between the functions and responsibilities of market professionals in both industries which are or would be subject to such a standard. Just as importantly, the policy imperatives applicable to the mortgage lending industry including fair lending and community investment requirements are inapplicable to the securities industry.

The Policy Imperatives Differ

While federal policy has been to encourage mortgage lenders to make credit available to as many borrowers as possible, by contrast those responsible for regulation of the securities industry have not made expansion of investment opportunities to under served persons or neighborhoods a major policy initiative. The consequence of the suitability requirement for a securities firm is that overly cautious broker-dealers will lose out on commissions. The consequence of a suitability requirement for mortgage lenders is that overly cautious lenders may violate the letter of federal anti-discrimination laws and the spirit of community reinvestment laws.

As noted, mortgage lenders have for decades been required by law to assure that they do not discriminate on the basis of race, religion, color, gender and membership in other protected classes. Lenders are required to increase availability of loans to under-served and minority populations and neighborhoods. The Fair Housing Act, ECOA and CRA encourage not only fair lending practices, but affirmative efforts to expand credit availability.

In part in response to these laws, using enhanced underwriting and loan pricing techniques, mortgage lenders have been successful in expanding the number of borrowers and neighborhoods they serve, while at the same time structuring loans that are safe enough to be attractive to buyers in the secondary market and purchasers of mortgage securities who are the principal source of mortgage credit for American home buyers.

Assuming there were modifications to fair lending and community reinvestment laws, which, to repeat,

47 The difference between duties for recommended transactions and mere order-taking was explained clearly in Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282 (E.D. La Feb. 6, 1974).

48 Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 337 F. Sup. 107 (N.D. Ala. April 15, 1971) ("The risk of the venture is upon the customer who profits if it succeeds and loses if it fails. When the transaction is closed in accordance with the understanding of the parties, the broker gets only his commission and interest upon advances.").

lenders do not favor, it might be possible to reconcile "suitability" requirements and these legislative mandates. However, until then, substituting a lender's judgment for a borrower's as to whether the borrower should be granted a loan that otherwise meets the lender's underwriting criteria is fraught with risk.

The Business Models Differ

Securities law requirements for determinations of suitability are predicated upon a business model under which the securities market professional acts as an agent, holding him or herself out as an expert adviser and counselor on investments to prospective investors. Securities brokers-dealers essentially function as intermediaries between the customer and the market. The public expects a securities broker-dealer to act on their behalf because of the way a broker-dealer holds himself out.

Mortgage lenders, on the other hand, are not intermediaries or agents of or fiduciaries for borrowers, do not hold themselves out in that manner and do not have a legal responsibility to represent the borrower's interests. Indeed, as noted by the NCLC, a residential mortgage transaction "is considered to be an arms length one in which the lender is entitled to its profits... and the borrower knows this."[49]

Lenders can and do offer valuable information to consumers. Lenders help consumers understand what mortgage products are available and for what mortgages they qualify. For this reason, it pays for consumers to see lenders early in the home buying process not only to determine what property they can afford but also to consider their financing choices in relation to their particular situations, including their income, credit and plans to stay in their homes. Nevertheless, lenders cannot as a legal matter serve as agents and fiduciaries for borrowers and at the same time fulfill their legal obligations to their companies.

The mortgage lender's primary duty is to those who entrust the mortgage lender with the funds used to finance the mortgage, be they depositors at a bank or purchasers of mortgages in the secondary market. Mortgage lenders are charged with performing due diligence regarding a borrower's ability to repay the loan, and secondary market investors in mortgage loans require representations and warranties from mortgage lenders that they have properly performed such due diligence on the borrowers and properties securing loans through underwriting, appraisals, title searches and other processes. Unlike the securities market professional, who takes a customer's money for investment, the mortgage lender provides money to the borrower in exchange for the legal promise of the borrower to repay the loan with interest.

Mortgage borrowers understand that the lender is not their agent. They apply for a loan from the lender who will decide whether or not to lend them the money. Mortgage borrowers shop for loans because they do not expect a mortgage lender to act on their behalf to secure the best rate and terms.[50]

Finding loans is not difficult for consumers. Advertisements in newspapers, television, and the internet offer borrowers a wide range of information on rates and terms available from mortgage lenders. Unlike the securities industry, where a customer generally does not shop among brokers or change them on a

49 National Consumer Law Center, The Cost of Credit: Regulation and Legal Challenges, § 12.9.3 (3rd ed. & Supp.) (quoting Sallee v. Fort Knox Nat'l Bank (In re Sallee), 286 F.3d 878 (6th Cir. 2002)).

50 This section concerns mortgage lenders, not mortgage brokers. However, the other points raised in this paper, i.e., that imposition of a suitability standard risk fair lending and homeownership gains, pertain to all mortgage originators.

regular basis, mortgage borrowers frequently shop from one lender to another looking for the best rate and terms available.

The role of the lender in many cases is to respond to the borrower's needs after the borrower decides whether to borrow and what his or her requirements demand. Order taking, which occurs in the mortgage lending industry, is exempt from the securities industry standard. To suggest that a lender should now move to the borrower's side of the transaction and effectively assume the role of a fiduciary for the borrower would radically alter the business model under which the mortgage business operates, and would assign mortgage lenders responsibilities which are at odds with their duties to mortgage investors.

Imposing a suitability standard on mortgage lenders would force them to be simultaneously responsible to the lender and the borrower, an impossible set of competing demands. If a mortgage lender had a requirement to assess suitability of the loan to the borrower, it would be as though, in the securities context, the suitability of the security for the buyer were determined not by the *buyer's* broker-dealer but rather the *seller's* broker, foisting a fiduciary duty upon the wrong party on the other side of the transaction.

Such an approach not only wreaks havoc on basic agency law, it also creates serious conflict of interest issues.[51] A suitability requirement would force the lender to assume the role of fiduciary for the borrower with the mandate to protect the borrower's interests (even at the detriment to the lender's interests) while at the same time seeking to secure a favorable return on the funds invested by the lender's shareholders and to secondary mortgage market investors.

Courts have consistently found that lenders do not have agency or fiduciary responsibilities to borrowers. Unlike a securities broker, who by definition acts on behalf of the customer's account, a lender in a loan transaction never enters into an agreement to act on behalf of the borrower. Rather, the transaction remains "at arms-length, where both parties act for themselves rather than as agents for each other."[52]

Not only is there no agency relationship, the lender and borrower are in fact counterparties in the transaction. Further, courts "are virtually unanimous in holding that the basic relationship between lenders and borrowers is an arm's-length transaction between creditors and debtors."[53] As one court stated, a fiduciary relationship would arise only if "the activities of both parties [go] beyond their operating on their own behalf and the activity is for the benefit of both."[54]

51 See, e.g., Restat. 2d of Agency, § 391 ("Unless otherwise agreed, an agent is subject to a duty to his principal not to act on behalf of an adverse party in a transaction connected with his agency without the principal's knowledge.").

52 See NCLC, The Cost of Credit, supra note 23; see also Daniel R. Fischel, *The Economics of Lender Liability*, 99 Yale L. J. 131, 146 (October, 1989).

53 Cecil J. Hunt II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship*, 29 Wake Forest L. Rev. 719 (1994) (citing, among other cases, Black Canyon Racquetball Club, Inc. v. Idaho First Nat'l Bank, 804 P.2d 900, 905 (Idaho 1991) (affirming the rule that "the relationship in a lender-borrower situation is a debtor-creditor relationship and not a fiduciary relationship.")

54 Union Planters Nat'l Bank, N.A., v. Jetton, 856 So.2d 674 (Miss. App., July 15, 2003.)

Imposition of a suitability determination requirement on lenders also would run afoul of traditional contract theory, which provides that a contracting party owes no duty to assume the position of the counterparty and decide if the contract meets the counterparty's needs. To the contrary, contracting parties are entitled to push their claims in the contract to maximize their self-interest, up to certain limits.[55] A suitability rule would turn that basic premise on its ear and require the lender to promote claims and terms contradictory to its own self-interest. This problem would be most acute where suitability may be extremely difficult to assess.

As noted, it is settled law that duties of good faith and fair dealing are already incumbent upon both parties to a contract.[56] The Restatement recites that "every contract imposes upon each party a duty of "good faith and fair dealing" in its performance and its enforcement."[57] Thus, prohibitions of fraud or material misrepresentation require no additional legal codification to enforce. The parties are covered by the implied covenants that are part of every contract.[58] The duty of "good faith and fair dealing" only arises after formation of the contract.[59] As noted, a suitability rule would essentially extend fiduciary duties to actions of contracting parties prior to the formation of the contract — the precise time when they are free to negotiate at arms length to advance their own interests.

It is Not Clear that the Suitability Standard is Working Well in the Securities Industry

The vagueness of the suitability doctrine in the securities industry has led to increased claims under the standard. NASD dispute resolution statistics reflect significant increases in claims against securities market professionals for the years 2001 to 2003, coinciding with the general stock market decline. These statistics suggest that investors who lose money are quick to claim that the recommendations of their brokers were inappropriate, even in spite of the requirement to prove scienter. There is no reason to believe that borrowers facing foreclosure would not assert similar defenses regardless of whether the loan was appropriate or not when made.

In fact, NASD has expressed concern about the magnitude of claims brought against market professionals and brokerage firms for unsuitability under NASD members' errors and omissions insurance policies. In 1998, 95 percent of the filings made with insurers under their policies were based on unsuitability claims.[60]

55 See Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 Del. Ch. LEXIS 215 at *76-77 (Del Ch. Dec. 30, 1991) (noting that "while contracting parties are not fiduciaries for each other, there are outer limits to the self-seeking actions they may take under a contract").

56 Restatement (Second) of Contracts § 205.

57 See also Fischel, *The Economics of Lender Liability*, 99 Yale L. J. 131 (1989) (citing to the Uniform Commercial Code § 1-203.); Easterbrook & Fischel, *Contract and Fiduciary Duty, Journal of Law & Economics*, 425, 438, vol. XXXVI (April 1993) ("Contract law includes a principle of good faith in implementation—honesty in fact under the Uniform Commercial Code, plus an obligation to avoid (some) opportunistic advantage-taking.")

58 Additionally, contract law also deals with situations where disclosure of material facts should be made, even by counterparties. For example, a person should disclose a fact if it would correct a mistake of the other party as to a basic assumption on which that party is relying in making the contract and if non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing. A person also should disclose a fact if the other person is entitled to know the fact because of a relation of trust and confidence between them. See Restatement (Second) of Contracts, § 161.

59 See NCLC, supra note 23 at n.652.

60 See Lowenfels and Bromberg, supra note 39.

Retaining the Current "Arms Length" Model in the Mortgage Lending Industry Works Best for Consumers

Mortgage lenders, operating within this country's sophisticated real estate finance system, respond to a number of influences in determining their ability to originate mortgages in a manner that is profitable, as well as safe and sound. The primary influence for lenders are the signals received from secondary mortgage market investors.

Lenders have no interest in originating mortgages that result in defaults, delinquencies or even late payments. For that reason, a lender's interests coincide with those of the borrower in that neither has a desire to enter into a transaction that will result in the borrower being unable to repay the loan.

A lender originating a large number of mortgages with an unacceptable level of risk will find itself facing significant price disadvantages in the secondary market. Thus, the market signals lenders when product features need to be altered. In this manner, the private market can and does correct for excessive risk even more effectively than it could be directed to do so by legal process, by virtue of suitability standard, or otherwise. A good example of this dynamic is that the market offered and then rejected loans that exceed the value of the collateral, the so-called 125 percent loans.

Despite the wide range of market innovations, some borrowers may obtain loans with terms that negatively impact their ability to repay. There is an obvious tension between the societal goal of encouraging market innovations that will expand borrowing and home ownership opportunities and the goal of protecting individual borrowers from overextending themselves. The fundamental goal that borrowers only obtain loans they can repay is shared by consumers, advocacy organizations, regulators and mortgage lenders alike. For this reason, the mortgage lending industry has a great stake in striving, along with advocacy organizations, legislators and regulators, to make the lending process as understandable and abuse-free as possible, and more work is needed toward this goal. However, imposing a suitability standard is not an appropriate solution and would run the risk of turning back the clock on innovations that have greatly expanded homeownership opportunities.

Because of the way the market works for lenders and borrowers and the challenges presented by a suitability requirement, consumers are better off if the "arms length" model of lender and borrower is retained. It will work even better if Congress, the agencies, industry and consumer organizations work to markedly improve financial literacy, licensing and disclosure requirements and enact a uniform national law with clear, objective standards to address lending abuses.

Changing interest rates and multiple refinancings have created a crop of seasoned and savvy mortgage consumers, but levels of sophistication vary among borrowers, and some borrowers need further education. Making lenders effectively responsible for a borrower's decisions does not fundamentally address the concern that some borrowers do not adequately understand the process of obtaining a loan or the loan products offered to them, it merely shifts the responsibility and burden to the lender even though the borrower, not the lender, is the best person to determine what is best for him or her.

There are at least three types of measures that would more directly respond to the problems of information adequacy and prevent predatory lending.

First, considerable resources should be committed to improving borrower education to raise the level of financial literacy, including incorporating this issue into general educational programs and increasing access to transaction-specific borrower counseling. Better financial education would empower all borrowers to shop effectively among the array of competitors in the marketplace.

Second, simplification of the mortgage process and all necessary consumer information would make it much easier for an empowered consumer to navigate the market, and such improvements are long overdue. Consumers today face a pile of disclosures when they apply for and close on a mortgage. Efforts at improvement need to streamline the existing mandated disclosures and information, and must be comprehensive and well considered. A successful effort would result in much more effective information on the benefits, costs and features of the loan options presented by lenders.

The risk-based pricing disclosure prescribed under the recent Fair and Accurate Transactions Act (FACTA) is a Congressional solution to better arming the borrower in the marketplace. Giving this solution a chance to work, along with markedly simplifying and improving the rest of the required disclosures, would meaningfully address the information asymmetry without risking hard won fair lending and homeownership gains.

Third, uniform lending standards that are clear and objective, but do not unduly restrict the market, would improve on the standards established under HOEPA to stop lending abuses. These standards must be national in scope to enhance competition in all markets for all borrowers, especially nonprime. Such standards will allow all borrowers to benefit from greater choices, competition and lower prices that a fair and fully functioning market brings.

Finally, while any increases in delinquencies and defaults are an important concern, prohibition of particular products is not a solution, certainly not to the many borrowers who have used a range of products effectively to realize their dream of homeownership and otherwise satisfy the financial demands that we all face.

Conclusion

The mortgage market works and the data demonstrate that fact. The market is serving more borrowers, who are benefiting today from innovation, unparalleled choices and competition resulting in lower prices and greater opportunities than ever before to build the wealth and wellbeing that homeownership brings. The market must be permitted to continue to do so.

While strong consumer protection is essential to the public interest, it is equally essential to assure a regulatory environment that serves and does not stem innovation in the marketplace. Such an environment would continue to allow lenders to provide borrowers the widest array of credit options to purchase, maintain and, as needed, draw equity from their homes to meet the demands of their lives. Also, while lenders must certainly assure that borrowers meet appropriate requirements, the institution of rigid requirements or subjective suitability requirements would not serve borrowers well; it would stem innovation, significantly increase lenders' costs and decrease competition which, in turn, would further increase borrowers' costs. Any new requirements in this area, therefore, must carefully consider all the consequences and balance all imperatives to truly serve the public interest.

Congress should resist pressure to enact market disincentives like a suitability standard that would harm consumers. Instead, Congress should turn its attention to the creation of a modern, workable and beneficial uniform national lending standard to help foster the market's remarkable innovations and opportunities.

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Testimony of Martin Eakes, CEO
Center for Responsible Lending and Center for Community Self-Help

Before the U.S. Senate Committee on Banking, Housing and Urban Affairs
"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]

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 guaranteed 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.

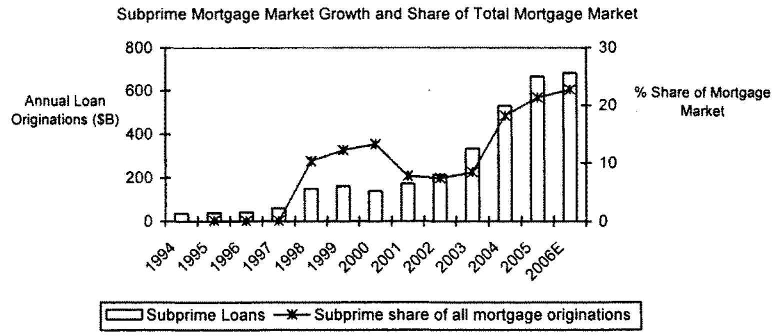
While there is a strong need for comprehensive reforms of the subprime mortgage market, including weeding out abuses in how mortgage servicers handle monthly payments, my primary focus in these comments will be on loan origination practices and how high-risk loans in the subprime market are supported 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. Prepayment penalties 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: "Steering," when predatory lenders push-market borrowers into a subprime mortgage even when they could qualify for a prime loan; kickbacks to brokers (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.

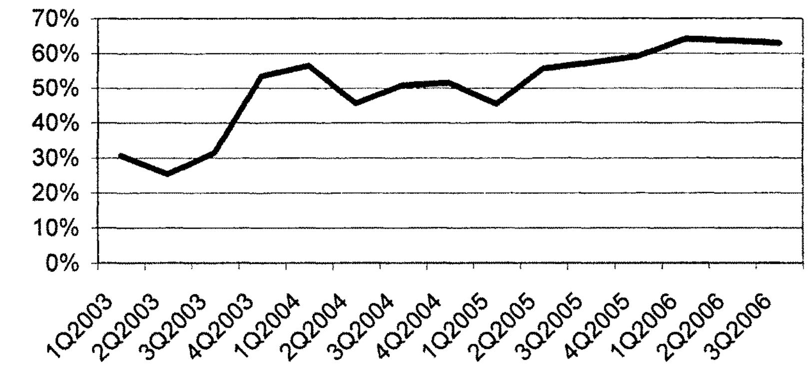
In addition, we now have a second generation of subprime lending abuses: high-risk loan products that were never intended for families who already have credit problems (discussed in more detail later in this testimony). The risks posed by these loans are magnified further because they are designed to 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 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. The pressing issue today is less the availability of home-secured credit than the terms on which it is offered. 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

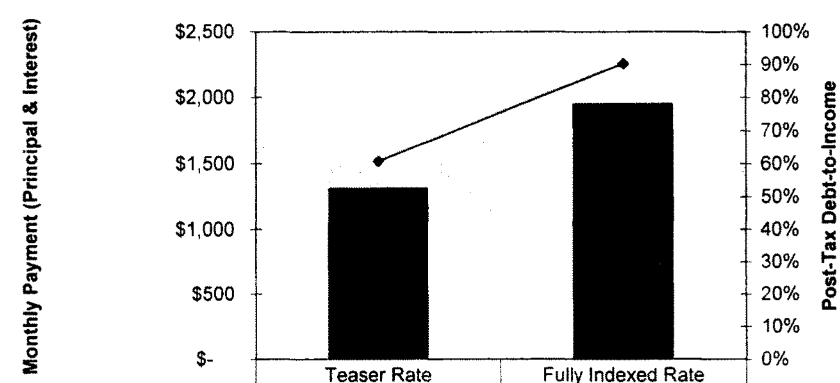
A. Risky Products: 2/28 "Exploding" ARMs

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)



	Teaser Rate	Fully Indexed Rate
Monthly Payment	$1,311	$1,948
Post-Tax DTI	61%	90%

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 . . .." "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."[46] 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.[47]

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."[48] 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.[49]

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.[50]

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.[51] 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."[52]

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.[53]

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.[54] 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[55] 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.[56] 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.[57]

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 all 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.[58] By contrast, the discretionary authority granted by subsection (l) refers to "mortgage loans" generally.[59]

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.[60] 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.[61] The Conference Report also urged the Board to protect consumers, particularly refinance mortgage borrowers.[62]

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. **<u>From affordable loan to escalating ARM .</u>**
   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 24th 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. **<u>Temporary lower payments—a prelude to shock.</u>**
   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 <u>not</u> 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. **<u>Unaffordable from the start.</u>**
   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

[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 <u>all</u> 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 <u>minus</u> one percentage point. Other borrowers have their ability to repay screened at the initial interest rate.[22]

<u>Additional Assertions By CFAL Answered</u>

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.

[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* Sharick, *et al*, note 33.

[47] 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.

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

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

[50] 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.

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

[52] 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).

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

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

[55] 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

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

[57] 15 USC Section 1639(l)(2).

[58] 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)."

[59] 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.

[60] 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."

[61] 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."

[62] "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.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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HEARING BEFORE THE

U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

ENTITLED

PRESERVING THE AMERICAN DREAM: PREDATORY LENDING PRACTICES AND HOME FORECLOSURES

STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®
FEBRUARY 7, 2007

The National Association of REALTORS® (NAR) is pleased to submit our views to the Senate Committee on Banking, Housing, and Urban Affairs for the hearing entitled, "Preserving the American Dream: Predatory Lending Practices and Home Foreclosures." We commend Chairman Dodd, Senator Shelby and members of the committee for holding this hearing on the very serious issue of problematic lending and high foreclosure rates facing our country, our cities and most importantly, our nation's consumers.

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association representing more than 1.3 million members and five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®.

REALTORS® Want to Prevent Predatory Lending

Abusive and predatory lending practices are a major problem for our nation's communities. While predatory lending occurs much too often in subprime markets, not all subprime loans are predatory. In fact, responsible subprime lenders have played an important role in helping millions of consumers achieve homeownership. Unfortunately, some lenders abuse their role and take advantage of vulnerable borrowers by charging extremely high interest rates and loan fees unrelated to risk, using aggressive sales tactics to steer consumers into unnecessarily expensive or inappropriate loan products, and advertising very low "teaser" interest rates that steeply increase after the first few years of the loan. The consequences of abuses in the subprime market are higher foreclosures leading to the loss of a family's home and savings and increased vacancy rates which, in turn, can cause all homes in the neighborhood to lose value.

Real estate professionals have a strong stake in preventing predatory lending because:

- Predatory lending erodes confidence in the Nation's housing system.

- In a credit-driven economy, the legislative and regulatory response to lending abuses can go too far and inadvertently limit the availability of reasonable credit for prime as well as subprime borrowers.
- To the extent the response to predatory lending constrains the ability of the secondary mortgage market to provide liquidity for home finance, consumers will find it more difficult and expensive to buy a home.
- Citizens of communities, including real estate professionals, are harmed whenever predatory lending strips equity from homeowners, especially when the predatory lenders concentrate their activities on certain neighborhoods and create a downward cycle of economic deterioration.

Problems Connected to Predatory Lending

There is no single definition of predatory lending because the term covers a wide range of abusive practices. Some practices may be predatory for one borrower but not for another because everyone's circumstances are different. Predatory lenders often take advantage of first-time homebuyers and others who may be vulnerable. Some examples of problems with predatory loans include, but most certainly are not limited to:

- **High interest rates and fees.** Predatory lenders often charge extremely high interest and fees that are added into the total amount of the loan the borrower must repay. These lenders charge what they can get away with, not a fair amount based on the credit history of the borrower.
- **Broken promises/"bait and switch."** Sometimes home buyers are offered a new loan or a refinance of an existing loan that seems to meet all of their needs only to find that interest rates and fees have changed when they get to the closing table. Agreeing to last-minute changes can cost thousands of dollars and result in a loan they just can't afford.
- **Loans that start low and go high.** Adjustable rate loans are popular in today's market, but many that seem to be affordable are likely to have steep cost increases in the future.

- **Loan "flipping."** Too many homeowners are persuaded to refinance their mortgage, sometimes repeatedly, when there is no real benefit. Even when a family receives some cash from a refinance, the gains should be weighed against the costs of excessive fees and a higher loan amount. Often a borrower has other options, such as obtaining a second mortgage instead of refinancing the entire existing mortgage.
- **Steering.** Some families who receive subprime loans could qualify for a much more affordable home loan, possibly even a prime loan. Predatory lenders use aggressive sales tactics to steer families into unnecessarily expensive loan products.

NAR Supports Amending HOEPA to Broaden and Strengthen its Coverage

NAR supports amending the Home Ownership and Equity Protection Act of 1994 (HOEPA), which establishes federal anti-predatory lending protections for high-cost mortgages. If Congress enacts significant HOEPA reform legislation, including many of the amendments listed below, NAR believes the result would be a significant reduction in predatory lending.

1. **Extend HOEPA to Purchase Money Mortgages.** The scope of HOEPA should be broadened to cover purchase money mortgages, and not be limited to refinancings and other loans taken out by existing homeowners. While predatory lending has been a particular problem in connection with refinancings by homeowners, homebuyers are also being victimized by predatory loans.

2. **Lower Triggers to Apply HOEPA to More Mortgages.** HOEPA applies to high-cost mortgages, measured in terms of high interest rates and high fees and points.
   - The existing interest rate trigger should be lowered so HOEPA applies to more mortgages, but the decision of exactly what level is appropriate will depend on the strength of the overall package of reforms. The current trigger for subordinate mortgages is 10 percent above the rate for comparable U.S. Treasury obligations. The Federal Reserve Board has exercised its discretion to lower the trigger to 8 percent for first mortgages.

- The definition of fees and points should be comprehensive (current law has too many exclusions), and the points and fees trigger should be set at about 5 percent of the loan. For example, the definition should include yield spread premiums and, if permitted, potential prepayment penalties. Some pending proposals would permit, in addition to the percentage cap, two bona fide discount points, which should be permitted, depending on the strength of the overall package of reforms.
- In addition, NAR should consider supporting an additional HOEPA trigger based on excessive loan-to-value ratios, again with the details depending on the strength of the overall package of reforms. Since appraisal fraud—appraisals above the real market value of the property—may be coupled with predatory lending, NAR recognizes that an LTV trigger may have limited impact. NAR is on record in support of appraisals that are independent, unbiased, and objective for all segments of the market.

3. **Protections from Predatory Terms and Conditions.** NAR supports a strong package of HOEPA reforms that includes as many of the following protections for high-cost HOEPA mortgages (and, where noted, other mortgages) as possible:
   - Seek to bar **prepayment penalties** but for all mortgages, not just high-cost HOEPA mortgages. If a complete prohibition is not feasible, support shortening the maximum permissible time for prepayment penalties from five years to three or preferably fewer years and capping them at a reasonable amount.
   - **Cap the amount of fees and points that may be financed at about 5%, plus up to two bona fide discount points.** This would minimize the ability of predatory lenders to hide the true cost to the consumer by avoiding the need for them to pay for excessive fees at settlement. Prohibit financing of fees and points in the case of a refinancing where the same lender made the loan being refinanced.
   - Prohibit **single premium insurance** (or any equivalent).
   - Prohibit **mandatory arbitration clauses,** because of the need to offer borrowers with HOEPA mortgages stronger protections. (Mandatory arbitration clauses are becoming infrequent in the prime market because Fannie Mae and Freddie Mac no longer purchase mortgages with mandatory arbitration clauses, and other lenders have stopped including them in their mortgages as well.)

- Continue to prohibit lenders from engaging in a pattern or practice of lending without regard to the **ability of the borrower to repay the loan.**
- For **home improvement contractor loans,** continue to prohibit direct payments of loan proceeds to home improvement contractors, and make assignees and holders of HOEPA home improvement mortgages subject to the same claims a consumer has against the seller, contractor, broker, or creditor.
- Prohibit anyone from **encouraging default.**
- Prohibit **mortgage flipping**—refinancing within one year unless the refinancing provides a "reasonable net tangible benefit" to the borrower.
- Require lenders, each year, to provide **two free pay-off statements** within seven business days of the request.
- As a general rule, permit **modification and deferral fees** only when there is a change to a HOEPA loan that benefits the consumer.
- Require all institutional mortgage lenders to **report payment history** of borrowers on a monthly basis. Prime mortgage lenders typically already report payment histories to credit reporting agencies (credit bureaus), so imposing reporting on all lenders should not impose an additional regulatory burden on prime mortgage lenders.
- Retain prohibitions against **balloon mortgages** for mortgages with terms less than five years and against **negative amortization.**
- Require **counseling** for prospective borrowers, to be provided by independent, certified counselors.

4. **Assignee Liability.** NAR opposes any weakening of originator or assignee liability for HOEPA mortgages. There is no reason originators should not remain liable for violations of law they commit in connection with making a mortgage loan. As between an innocent borrower that risks losing the home and an innocent assignee in the secondary market that inadvertently purchases a HOEPA mortgage, the interests of the borrower should generally prevail. Fannie Mae, Freddie Mac, and others have policies against the purchase of HOEPA mortgages, and current law has not impaired the secondary market.

HOEPA currently imposes liability on assignees of HOEPA mortgages and permits borrowers to defend against foreclosure based on defects in the mortgage, with limited exceptions. A HOEPA mortgagor in default cannot assert certain claims and defenses against an assignee that can demonstrate, by a preponderance of evidence, that a reasonable person could not determine that it had purchased a HOEPA mortgage, based on certain factors. But even where an assignee can make that showing, the mortgagor retains certain rights, including the right of rescission for certain violations.

NAR supports proposals to strengthen HOEPA, so long as they would not disrupt the secondary market. For example, HOEPA should continue to include reasonable limits on the amount of damages a mortgagor can claim, and class action litigation should not be permitted.

NAR Supports Consumer Education

NAR is very concerned that some borrowers do not understand the significant risks associated with a predatory loan and do not know how to avoid them. Last year, NAR, in partnership with the Center for Responsible Lending, issued a consumer education brochure entitled, "How to Avoid Predatory Lending," a copy of which is attached to this statement. The brochure emphasizes how important it is for consumers to make sure they shop for the lowest-cost loan and ask questions like,

- What is my credit score? Can I have a copy of my credit report?
- What is the best interest rate today? Do I qualify?
- Is the loan's interest rate fixed or adjustable?
- What is the term (length) of the loan?
- What are the total loan fees?
- What is the total monthly payment? Does this include property taxes and insurance? If not, how much will I need each month for taxes and insurance?
- Is there an application fee? If so, what is it, and how much is refundable if I don't qualify?
- Are there any prepayment penalties? If so, what are they and how long do they last?

Conclusion

Predatory lending can be a disaster not only for the borrower and his or her family, but for the community as well. Problematic loans are often made in concentrated areas and are more likely to result in foreclosures. High foreclosures of single-family homes are a serious threat to neighborhood stability and community well-being. Foreclosures can lead to high vacancy rates which, in turn, can devastate the strength and stability of communities.

REALTORS®, help families achieve the dream of homeownership. The National Association of REALTORS® supports responsible lending with increased consumer protections to ensure that the "dream" our members help fulfill does not turn into a family's worst nightmare. NAR stands ready to work with Congress on the important issue of predatory lending and we are happy to make available to your constituents our "How to Avoid Predatory Lending" consumer education brochure. Thank you.

CENTER FOR RESPONSIBLE LENDING

CRL RESEARCH ON SUBPRIME FORECLOSURES, MINORITY PRICING DISPARITIES, AND STATE LAWS IS ACCURATE AND ON TARGET

The Mortgage Bankers Association (MBA) recently issued comments on three studies published by the Center for Responsible Lending (CRL) in 2006. In these comments, the MBA attempts to refute CRL's key findings that

- Almost 20% of recent subprime borrowers will lose their homes over the next few years;
- African-American and Latino subprime borrowers are more likely to receive a high-cost loan, compared to white borrowers; and
- State anti-predatory lending laws have not dampened the supply of subprime mortgage credit with terms not targeted by the laws or raised prices on these loans.

However, the MBA's critique of CRL's research fundamentally misrepresents our research data and methodologies in order to cast doubt on the studies' findings. This has been MBA's typical pattern of attack, even though the MBA has never produced any research of its own to prove CRL's findings false or erroneous.

Our specific response to the MBA's critiques appears below.

CRL'S "LOSING GROUND" STUDY: 1 IN 5 BORROWERS TO FAIL

MBA Critique: CRL's 20% foreclosure rate includes borrowers who are able to avoid foreclosure by selling their home or refinancing their loans.

CRL Response:

- Our study measured both loans that ended in foreclosure and delinquent loans that were "cured" by refinancing or selling a home, but CRL's estimate strictly covers loans that ENDED in foreclosure. This is clearly spelled out at the very beginning of CRL's "Losing Ground" report: *"We project that one out of five (19 percent) subprime mortgages originated during the past two years will end in foreclosure. This rate is nearly double the projected rate of subprime loans made in 2002, and it exceeds the worst foreclosure experience in the modern mortgage market, which occurred during the "Oil Patch" disaster of the 1980s."*[1]
- CRL's projection is consistent with findings from recent studies by researchers at the St. Louis Federal Reserve and University of North Carolina.[2] In fact, CRL's estimate may be conservative, as Lehman Brothers recently forecast a 30% foreclosure rate on 2006 subprime loans.[3]

MBA Critique: CRL relies on overly pessimistic assumptions about borrowers' ability to pay off their loans and local housing appreciation rates.

CRL Response:

- Our study makes no assumptions about a borrower's ability to pay off their loan. Rather, we measured the actual performance of over six million subprime loans originated over a seven-year period.
- The housing appreciation forecasts utilized in our study came from Moody's Economy.com, an independent provider of economic and financial research to many banks, insurance companies, and financial services firms. According to Moody's Economy.com, these forecasts were derived from econometric models that incorporated "a wide range of variables…including, but not limited to, everything from low mortgage rates and more aggressive mortgage lending, to solid demographic trends and a better job market, to constraints on the supply of new housing."[4]

MBA Critique: MBA's housing projections and statistics on subprime delinquency and foreclosure are much more positive, and there is no other data source that CRL could have used to track cumulative foreclosure rates.

CRL Response:

- MBA's lower delinquency and foreclosure statistics reflect only the percentage of outstanding loans that are delinquent or in foreclosure <u>at a specific point in time,</u> (so loans that have been foreclosed on in the past are not part of the MBA's statistic), while CRL's statistics measure the performance <u>over the life of the loans</u>. The cumulative foreclosure rate is commonly used by mortgage lenders, investors, insurers, and rating agencies to predict the risk and profitability of a given set of loans.
- Contrary to MBA's claim, there are at least two commercially-available data sources that provide comprehensive data on subprime loan performance that enable users to calculate cumulative foreclosure rates.[5]

MBA Critique: Subprime loans are an important component for increasing homeownership.

CRL Response:

- Loans in the subprime market are typically debt consolidation refinance loans and do not create new homeownership opportunities. According to the MBA's statistics, only 11% of subprime loans are used by first-time homebuyers.[6]
- Loans that borrowers cannot afford do not lead to lasting homeownership. Comparing an 11% increase in homeownership with projected default rates of 19.4% for recent subprime loans, <u>subprime lending appears to result in a NET LOSS of homeownership in its current form</u>

- In addition, most borrowers who get subprime loans later refinance into new 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, CRL roughly estimates in *Losing Ground* that actual subprime borrower foreclosure rates will be over 35%.

CRL'S "UNFAIR LENDING" STUDY: AFRICAN-AMERICANS AND LATINOS PAY MORE FOR SUBPRIME LOANS, REGARDLESS OF RISK

MBA Critique: The CRL study does not account for all risk factors, especially debt-to-income ratios (DTI).

CRL Response:

- The CRL paper accounts for all of the borrower risk factors included in the HMDA analysis by the Federal Reserve, and the vast majority of risk factors used by lenders to determine the price of a loan.
- CRL's study also included risk factors that the MBA itself has cited in the past as explanations for pricing disparities (e.g. LTV, credit score, income documentation, etc.).[7]
- While CRL's analysis did not include debt-to-income ratio, the analysis does control for loan amount and borrower income, which make up a large majority of the DTI measurement. In addition, DTI generally is NOT used in determining loan pricing, but instead as part of the underwriting decision about whether a loan should be originated.

MBA Critique: The study uses a small sample of loans that is not representative of the subprime market.

CRL Response:

- CRL's data comes from over 30 subprime lenders and <u>is</u> representative of the broader subprime market. This is clearly described in Appendix 3 of the report, where we show that the average values for characteristics of the "matched" loans are consistent with the average values of the entire dataset and overall market.
- CRL's use of a smaller sample of loans required that the relationship between variables be very consistent to result in statistical significance. That is, the fact that CRL found statistically significant relationships between race/ethnicity and likelihood of receiving a higher-cost loan with a relatively small sample size makes the validity of these findings even <u>stronger</u>.

MBA Critique: CRL's findings are contradicted by the Federal Reserve Board's HMDA analysis.

CRL Response:

- The Federal Reserve HMDA analysis uses data from only eight subprime lenders, and there is evidence that the composition of loans from these lenders is fundamentally different from that of the overall subprime market.
- The Fed's research methodology ignores the effect that the broker plays in pricing loans to African-Americans or Latinos, even though mortgage brokers originate 71% of subprime loans.[8]
- The Fed's report also does not contain important information on the research methodology, and it does not provide results for the control variables that were used in the analysis. This lack of clarity makes it difficult to determine what conclusions one can reasonably draw.

CRL'S "BEST VALUE IN THE SUBPRIME MARKET" STUDY: STATE ANTI-PREDATORY LENDING LAWS ARE WORKING

MBA Critique: CRL claims the declining volume of loans with certain loan features means fewer "predatory" loans are being made. There are also problems with the study's methodology and sampling techniques.

CRL Response:

- The MBA can dispute whether certain loan terms (e.g. subprime prepayment penalties) are predatory, but nonetheless these specific loan terms were targeted for reform by policymakers, and CRL simply measures whether state laws had their intended effect of reducing the volume of loans with these features. The MBA also doesn't dispute CRL's finding that loans with targeted terms were indeed reduced, while loans with terms not targeted by state laws were not.
- MBA's other concerns are not specific enough for us to address them. Again, they have not issued any study of their own to refute our findings.

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[1] *Losing Ground* Executive Summary, page 3.

[2] Anthony Pennington-Cross and Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages,* Working Paper 2006-042A Federal Reserve Bank of St. Louis (July 2006). 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,* Kenan Institute for Private Enterprise, University of North Carolina at Chapel Hill (January 25, 2005).

[3] Lehman Brothers Equity Research. *Mortgage Finance Industry Overview.* p.4 (December 2006).

[4] Mark Zandi, Celia Chen, and Brian Carey. *Housing at the Tipping Point: The Outlook for the U.S. Residential Real Estate Market.* Moody's Economy.com, p. 6. (October 2006).

[5] Databases offered by McDash Analytics (Ponte Vedra Beach, FL) and First American Real Estate Solutions (Santa Ana, CA)

[6] 45% of subprime loans for home purchase times 25% going to first time homebuyer.

[7] Statement of Douglas Duncan, Senior Vice President for Research and Business Development and Chief Economist, Mortgage Bankers Association before the Subcommittee on Financial Institutions and Consumer Credit Of the House of Representatives Committee on Financial Services.
p. 5. (June 13, 2006).

[8] MBA Research Data Notes, *Residential Mortgage Origination Channels*. September 2006.

TESTIMONY SUBMITTED BY THE:

CONSUMER MORTGAGE COALITION

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

"Preserving the American Dream: Predatory Lending Practices and Home Foreclosures"

February 7, 2007

The Consumer Mortgage Coalition ("CMC"), a trade association of national residential mortgage lenders, servicers, and service providers, appreciates the opportunity to submit its written testimony concerning predatory loan practices and home foreclosures to the Senate Committee on Banking, Housing, and Urban Affairs.

CMC and its members condemn those lending practices that truly are "predatory" and injurious to consumers. While truly "predatory" practices are indefensible, legitimate and beneficial lending practices must not be grouped incorrectly with predatory practices.

CMC's testimony explains that innovations in the mortgage lending industry and secondary mortgage market have made mortgage credit more available and more affordable to consumers—of every race and ethnicity and of every income level—than at any time in our nation's history. Homeownership has increased in recent years to record highs.

Contrary to some recent assertions, overall foreclosure rates (about 1% nationally for all loans), while certainly higher than anyone would like, are within historical norms. Moreover, while the mortgage lending market is adjusting – and will continue to adjust – to the recent rise in non-prime delinquencies, as it has in prior cycles,[1] the opportunity to own a home remains by far the most significant gateway to economic success for millions of Americans seeking to improve their and their family's lives. CMC and its members urge the Committee to be cautious before taking steps to fix what is not broken.

Attached is a primer which discusses the history of non-prime lending, its benefits to consumers, and many of the terms that arise in debates regarding such lending. Also, we would like to refer the Committee to an economics report prepared by an economist at Friedman Billings Ramsey & Co., published in June 2006 in The MarketPulse by LoanPerformance (www.loanperformance.com) that sheds light on the underlying factors causing higher defaults and foreclosures, which is discussed in more detail below.

Preserving the American Dream

CMC commends the Committee's choice of the title for this hearing, which is not only appropriate but correctly frames the issue at hand. Homeownership has long been an integral part of the American dream. It not only benefits the individual homeowners, but also benefits communities and our nation generally. Practices which make the dream of homeownership more widely available and more affordable to consumers should be applauded, not limited.

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1 The market constantly adjusts the pricing and availability of credit to address changes and risks in the economy. While the effects of a too plentiful supply of credit can lead to adverse conditions, a too restrictive flow of credit, a "credit crunch," can also have devastating, ripple-effect consequences on our communities.

Mortgage credit has not always been as available and affordable as it is today.[2] Prior to the 1990's, the vast majority of lenders would make only prime loans (i.e., loans to the lender's most creditworthy customers). Additionally, the number of mortgage products available to consumers was limited. Either the consumer met fairly rigid, conventional lending standards and received a prime loan or the consumer could not get a loan. And even when the consumer met those conventional lending standards, the products available to the borrower were limited.

If the consumer could not meet the conventional lending standards, the only market alternative was a finance company, which made mortgage loans with very high rates (often at double or more the rate on prime loans). Finance company lending standards were focused primarily on the value of the collateral (i.e., the loan amount was not a high percentage of the value of the property serving as collateral for the loan) and on the borrower's income. Loans were typically second mortgages for smaller amounts (under $50,000).

As technology improved and underwriting tools became more sophisticated, lenders (and investors in the secondary market) were able to assess the risk of different interest rates on individual loans. Lenders were not only able to offer a wider range of products better tailored to borrowers' varying circumstances, but could tailor the price of the product to the risk level of the individual borrower. The combination of innovative mortgage products and "risk-based pricing" benefits all consumers. Consumers with good credit can obtain credit products at lower prices than ever before. Consumers that pose greater credit risk benefit not only by having greater access to mortgage credit than ever before, but also in having access to credit products that are more affordable than ever before.

Recent statistics show that the mortgage lending industry is not only preserving but furthering the American dream of homeownership. In recent years, homeownership has been at unprecedented highs. In the fourth quarter of 2006, the U.S. Census Bureau reported that U.S. homeownership was at a near-record level of 68.9%, up from 65.4% from the same quarter in 1996—meaning approximately 9.7 million more people own homes today than in 1996.[3] This time period roughly correlates with the development of the secondary market for non-prime mortgages and consequent expansion of the availability of non-prime mortgages. Homeownership among minorities also continues at near-record levels.[4]

The increased availability and affordability of mortgage credit—resulting in large part from innovative mortgage products and risk-based pricing—is an important factor

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2 A more detailed, but still brief, discussion of the history of non-prime mortgage lending is included in the attachment to this testimony.

3 *See* U.S. Department of Commerce, *Census Bureau Reports on Residential Vacancies and Homeownership*, at 4 (Jan. 29, 2007), *available at* http://www.census.gov/hhes/www/housing/hvs/qtr406/q406press.pdf.

4 *See id.* at 8.

leading to the increased homeownership in recent years.[5] Imposing limitations on these products or on risk-based pricing will serve only to decrease the availability and affordability of mortgage credit, and undoubtedly will have a negative impact on homeownership rates. Such limitations will harm, not preserve, the American Dream.

What Is, and What Is Not, "Predatory" Lending

While no universally accepted definition of "predatory lending" exists, it clearly is a term used to cast certain lending practices in a negative light. Some critics of certain lending practices have attempted to brand certain practices as "predatory." This term might rightly be applied to practices designed to cheat consumers out of their money and homes, but it is not properly applied to the vast majority of non-prime lending transactions which preserve and increase homeownership.

Notwithstanding the lack of a universally accepted definition of "predatory" lending, guidance by the Federal Reserve Board regarding predatory practices in home equity lending is instructive. Former Governor Gramlich has testified that there are two types of abusive practices in home equity lending, and mortgage lending generally: blatant fraud or deception, and the use of practices that are not inherently abusive but can be misused to injure consumers:

> "[A]busive practices in home-equity lending take many forms but principally fall within two categories. One category includes the use of *blatantly fraudulent or deceptive techniques* that may also involve other unlawful acts, including violations of HOEPA [the Home Ownership and Equity Protection Act]. These practices occur even though they are illegal. For example, loan applicants' incomes and ability to make scheduled loan payments may be falsified, consumers' signatures may be forged or obtained on blank documents, or borrowers may be charged fees that are not tied to any service rendered. The other category of abuses involves various techniques used to manipulate borrowers, *coupled with practices that may ordinarily be acceptable but can be used or combined in abusive ways*. . . . [S]ome loan terms that work well for some borrowers in some circumstances may harm borrowers who are not fully aware of the consequences. For example, a consumer may not understand that a loan with affordable monthly payments will not amortize the principal or that the consumer may have to refinance a balloon payment at additional cost."[6]

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5 *See, e.g.*, Mark Doms & Meryl Motika, *The Rise in Homeownership*, FRBSF Economic Letter 2006-30, at 2-3 (Nov. 3, 2006), *available at* http://www.frbsf.org/publications/economics/letter/2006/el2006-30.pdf.

6 Testimony of Gov. Edward M. Gramlich before the Committee on Banking and Financial Services, U.S. House of Representatives (May 24, 2000) (emphasis added).

Predatory lenders who are disregarding existing legal requirements—including, in many cases, prohibitions against fraud and forgery that predate current consumer protections by many centuries—will not be deterred by additional rules. Instead, public policy should focus on more effective and sophisticated enforcement of those existing requirements.

The remedies for practices that ordinarily are acceptable but may be used in abusive ways depend on the particular practice and often on the particular circumstances. In its September 20, 2006 testimony before this Committee's Subcommittees on Housing and Transportation and Economic Policy, CMC discussed in detail many specific practices that are assailed by critics as "predatory."[7] The attached non-prime lending primer also discusses many of the legitimate and beneficial practices that are criticized as "predatory." CMC respectfully refers the Committee to the discussions contained in those documents.

CMC urges the committee to recognize that many of the so-called "predatory" practices are, in fact, beneficial to consumers and contribute to making loan products available and affordable to those who most need them. Inappropriate limitations on such practices will result in a contraction in mortgage credit availability and a decrease in its affordability—neither of which preserve or further the American dream of homeownership.

The Truth About Foreclosure – Need for GAO Study

Recent foreclosure forecasts by an advocacy group[8] have created much excitement over foreclosures in the sub-prime mortgage market. In the experience of CMC and its members, these forecasts are grossly exaggerated. While CMC's members have observed an up-tick in mortgage foreclosure rates, given the cyclical nature of the mortgage market this up-tick is not unexpected. CMC urges the Committee to have the Government Accounting Office conduct an independent study of foreclosure rates to ensure that the Committee makes its policy determinations based on reliable data. One advocacy-driven study should not be the basis for important public policy decisions.

Moreover, even though foreclosures have increased slightly, it is the experience of CMC and its members that the vast majority of delinquencies and foreclosures are not due to loan terms or products, but are due largely to the same factors that have led to delinquencies and foreclosures historically: job losses, divorce, and medical problems. The Mortgage Bankers Association of America recently observed the same thing:

> Mortgage delinquencies are still caused by the same things that have historically caused mortgage delinquencies: "life events," such as job loss, illness, divorce or some other

[7] *See* Testimony of the Consumer Mortgage Coalition Before the Committee on Banking, Housing, and Urban Affairs (Subcommittees on Housing and Transportation and on Economic Policy), United States Senate, "Calculated Risk: Assessing Non-Traditional Mortgage Products", at 9-17 (Sept. 20, 2006).

[8] Ellen Schloemer, et al., *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Consumers* (Dec. 2006).

> unexpected challenge. Foreclosures following delinquencies may be caused by the inability to sell a house due to local market conditions after one of the above items has occurred.[9]

It has also been the experience of CMC and its members that when poor job markets and other negative economic factors prevail in an area, foreclosure rates tend to rise. For example, the consumer advocacy group North Carolina Justice Center has shown that while the numbers of foreclosures (not just the rates of foreclosure) decreased state-wide in North Carolina in both 2004 and 2005, the numbers of foreclosures in particular counties varied more widely.[10] Such variances are much more likely to be a result of local economic factors than the result of any particular lender practices, products or loan terms.

This is supported by the economics report, "Explaining the Higher Default Rates of the 2005 Origination Year" prepared by Michael Youngblood, Managing Director, Asset-Backed Securities Research, Friedman Billings Ramsey & Co., published in June 2006 in The MarketPulse by LoanPerformance (www.loanperformance.com). The report notes that while the default rate at 20 months of adjustable rate mortgage (ARM) subprime securities was higher in 2005 than in 2003 or 2004, it was lower than the default rate at 20 months on similar securities originated from the years 2000 through 2002. Moreover, the report concluded that the reason the default rate on these securities was higher in 2005 than in 2003 or 2004 was attributable not to increases in short-term interest rates, nor to the erosion of underwriting criteria, but to weak economic factors in specific metropolitan statistical areas (MSAs) of the country, for example, weak labor market conditions in areas where subprime borrowers depend on employment by automobile manufacturers and related companies, particularly, but not exclusively, in the Midwest, weak labor markets in New England, and the impact of Hurricanes Katrina and Rita on Louisiana and Mississippi.

Some advocacy groups have also put forward anecdotal stories to support their calls for government action. Many of these anecdotes, however, involve fraudulent lender practices. Lenders who engage in fraudulent practices already ignore currently existing prohibitions on such practices. New limitations on loan products and terms will not deter such bad actors, but will only serve to limit the ability of responsible lenders to provide affordable credit to those who need it.

Such anecdotes are also selected to maximize negative impact. They do not include the millions of stories of consumers who have been able to purchase and retain homes, build

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[9] Mortgage Bankers Association, *The Residential Mortgage Market and Its Economic Context in 2007*, at 31, *available at* http://www.mortgagebankers.org/files/News/InternalResource/48215_TheResidentialMortgageMarketandItsEconomicContextin2007.pdf.

[10] *See* http://www.ncjustice.org/media/library/668_freclsrestatsncadminoffcts.pdf. While the numbers of foreclosures increased in some years, these numbers can only be understood properly in the context of the total new homes, which also increased.

equity, and pay emergency expenses as a result of mortgage credit. The sad reality is that there will always be some number of consumers who default on their loans. But, that number has been and continues to be relatively small. The misfortunes of a few should not deprive the many of opportunities to own their own homes and to make their own financial choices. CMC urges the Committee to consider the many success stories when considering the negative anecdotes.

CMC also urges the Committee to consider the many steps lenders and servicers take to avoid foreclosures. Lenders, servicers, and investors lose substantial amounts of money on each foreclosure. A Federal Reserve study has noted that

> When a borrower defaults on a home mortgage, the lender may attempt to recover its losses by repossessing and selling the property. However, estimated losses on these foreclosures range from 30 percent to 60 percent of the outstanding loan balances because of legal fees, foregone interest, and property expenses.[11]

Because a failed loan transaction is costly to all concerned, lenders design their underwriting criteria to avoid foreclosures. Lenders monitor closely the performance of loans and adjust their underwriting standards to avoid making loans that will default. Lenders and servicers also have developed programs to help borrowers through financial difficulty where possible, including encouraging customers to work with HUD-approved credit counseling agencies and offering flexible repayment plans. Lenders and servicers are better off if they can find ways to help the borrower avoid default. And, to the extent foreclosures increase, market forces compel lenders and servicers to tighten underwriting criteria and take steps to assist borrowers in avoiding default and foreclosure. From the perspective of lenders and servicers, foreclosure is a highly undesirable, but occasionally necessary, last resort.

Nevertheless, CMC urges the Committee to consider the negative impact any limitation on foreclosure ability will have on the availability and affordability of mortgage credit to consumers. Mortgage credit is cheaper than unsecured credit because lenders and servicers can foreclose if the borrower defaults. While foreclosure usually falls far short of making the lender or investor whole, it serves to reduce the loss the lender/investor faces on the defaulted loan. If lenders and servicers are limited (either intentionally or inadvertently) in their ability to foreclose when a borrower defaults, the lender or investor will face a vastly increased risk of loss which will be reflected in higher prices and decreased availability of mortgage credit—a result that will deprive many Americans of the dream of homeownership.

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[11] Karen M. Pence, *Foreclosing on Opportunity: State Laws and Mortgage Credit*, at 2 (May 13, 2003), *available at* http://www.federalreserve.gov/pubs/feds/2003/200316/200316pap.pdf.

Consumer Education is the Key

Instead of limiting lenders/servicers ability to foreclose on delinquent loans, CMC suggests that improved methods of educating consumers about their loans is a preferable means of minimizing delinquency and foreclosure.

First, a simplified, understandable disclosure of key information about the loan would enable consumers to better understand their credit obligations and comparison shop for loans. A common feature of most allegations of predatory lending is that the borrower was either confused or deliberately misled about key features of the loan. If the borrower receives a clear disclosure of these key features early in the transaction, it will be more difficult for an abusive lender or broker to misrepresent the terms of the loan and the borrower will have time to seek financing from other sources if the terms are unfavorable.

Second, CMC has long advocated a robust three-step program to increase public awareness and improve consumers' understanding of their loan obligation:

1. *Public Service Campaign*

Federal policymakers should implement an ongoing, nationwide public service campaign to advise consumers, but particularly the more vulnerable such as senior citizens and the poorly educated, that they should seek the advice of an independent third party before signing any loan agreements. Public service announcements could be made on radio and television, and articles and notices could be run in local newspapers and selected publications.

2. *Public Awareness Infrastructure*

Once alerted, consumers will need to be able to avail themselves of counseling services from unbiased sources. Those sources can always include family and friends and industry participants. In addition, however, a nationwide network should be put in place to ensure that all consumers can easily access advice and counseling to help them determine the loan product that best fits their financial needs. A public awareness infrastructure could be built out that would include 1-800 numbers with independent counselors, using sophisticated computer software, to help consumers talk through the loan product they are considering. In addition, programs could be developed with community organizations and other organizations serving senior citizens to provide on-site counseling assistance at local senior and community centers and churches. HUD's 800 number for counseling could be listed on required mortgage disclosures as an initial step to increase awareness of available advice.

3. "Good Housekeeping Seal of Approval" for On-Line Mortgage Calculators

Over 8 years ago, the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development issued a *Joint Report on the Real Estate Settlement Procedures Act and Truth in Lending Act* ("Joint Fed/HUD Report") recommending, among other things, that the government develop "smart" computer programs to help consumers determine the loan product that best meets their individual needs. Obviously, great strides in technology have occurred since then, with many mortgage calculators or "smart" computers available online. Since these computer programs have been already developed by the private sector and are widely available, a more appropriate role for the government today would be for the federal government to approve a limited and unbiased generic mortgage calculator module that could be incorporated into any online site that helps consumers evaluate various loan products.

We note that, appropriately, this hearing is occurring during National Consumer Protection Week (NCPW) (observed this year February 4-10). The theme of NCPW 2007 is "Read Up and Reach Out: Be an Informed Consumer," and it aims to encourage people to take advantage of the wealth of information available from government agencies and national and local consumer organizations that can help individuals make smart buying decisions and avoid frauds. This could not be more apropos to the issues being addressed today. CMC takes consumer education very seriously and believes it is the best way to enable people to protect themselves. In the words of FDIC Chairman Sheila Bair, "We know that when people learn how to make smart financial decisions and guard against fraud, they are protecting themselves and their family as well as their local community."

CMC is convinced that both consumers and lenders are better off if lenders have the freedom to offer and consumers have the freedom to choose from the widest range of financial options. Consumers, however, must be put in a position to make an informed decision that is most appropriate for their needs and situation.

* * *

CMC appreciates the opportunity to submit its testimony on issues relating to so-called "predatory" lending and foreclosures.

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Non-Prime Mortgage Lending: A Primer

Non-prime mortgage lending increasingly has received attention from law and policy makers, regulators, economists, consumer advocates, the plaintiffs' bar, and the industry. Some have wrongly tried to imply that non-prime lending is usually "predatory" or discriminatory. To aid in understanding non-prime mortgage lending and the issues raised in relation to it, the Consumer Mortgage Coalition has prepared the following primer on non-prime mortgage lending. This primer discusses briefly the history of non-prime mortgage lending, its benefits, and many of the key issues raised in the discussions surrounding it.

WHAT IS NON-PRIME MORTGAGE LENDING?

Non-prime mortgage lending (also called "sub-prime" lending) is a general term used to refer to lending that is not "prime" lending (i.e., lending to a lender's most creditworthy customers). "Prime" loans are loans originated into a loan program with low-risk underwriting parameters across the board, including the borrower's personal credit history, the amount of the loan compared to the value of the collateral, the type of dwelling that will act as collateral, the amount of the mortgage payment (and all debt payments collectively) compared to the proven earnings capacity of the borrower, the level of borrower assets and reserves compared to the monthly mortgage payment, the purpose of the loan, whether the borrower will reside in the collateral property, and other factors. Non-prime loans are loans originated into a loan program that does not require the loan to meet one or more of the low-risk underwriting parameters required for "prime" status. In general, the more a loan diverges from "prime" parameters—both in terms of the number of parameters that are divergent and the degree of the divergence—the greater the risk of the loan.

Lenders, and the investors to whom the lenders sell the loan, require a non-prime borrower to pay a higher price in return for, among other things, the lender taking a greater risk. As lenders and investors gain real-life experience with mortgage loan performance, they work to adjust the weighting of the different criteria (e.g., how important is the debt-to-income ratio compared to the credit score compared to occupancy status) as well as the risk associated with the different parameters (e.g., is a 80% loan-to-value ratio ("LTV") riskier than a 75% LTV?). When lenders create new products, they use loan performance data to convince mortgage-backed securities investors, credit enhancers (such as mortgage insurance or bond insurance companies) and ratings agencies that they will be able to reasonably predict the performance of the loan and that the investors are fully compensated for the additional risk that they are taking.

One very significant underwriting criterion is the borrower's credit history. Although lenders can view credit history differently, many use the borrower's credit score as a shorthand for understanding the borrower's credit quality. Companies that create credit scores—the best known one is the Fair Isaac Company and its ubiquitous FICO® score—

statistically analyze large amounts of credit history data (including past bankruptcies, foreclosures, timely or untimely payments, amount of unused credit accessible to the consumer, length of credit history, types of credit used, and other factors) and correlate that data with loan performance to create an algorithm that summarizes the likelihood of borrower default into a single number. Credit scores range from 300-850, with the median FICO score currently just over 720. The lower the score, the greater the risk that the consumer will not repay his or her loan. Bank regulators have generally considered loans to borrowers with credit scores below 660 to be non-prime although the mortgage market has managed to make prime loans to certain borrowers with credit scores as low as 620-640.

Most forms of credit in the United States—including credit card loans, auto loans and personal loans—have used the credit score as the principal underwriting criteria for many years. In mortgage lending, credit scores became a significant factor only in the 1990s, and some lenders have developed a more specific type of credit score called a mortgage score that aims to correlate credit history with likelihood of borrower default on a mortgage loan.

A BRIEF HISTORY OF NON-PRIME MORTGAGE LENDING

Prior to the 1990s—limited options for non-prime borrowers

Traditionally, prime and non-prime loans were treated completely differently by lenders. The vast majority of lenders would make only prime loans. Either the consumer met fairly rigid, conventional lending standards and received a prime loan or the consumer could not get a loan.

If the consumer could not meet the conventional lending standards, the only market alternative was a finance company, which made mortgage loans with very high rates (often at double or more the rate on prime loans). Finance company lending standards were focused primarily on the value of the collateral (i.e., the loan amount was not a high percentage of the value of the property serving as collateral for the loan) and on the borrower's income. Loans were typically second mortgages for smaller amounts (under $50,000).

There was essentially no mortgage market between these two extremes. Thus, borrowers who could not satisfy the criteria for "prime" loans often had no option other than to obtain smaller second mortgage loan from a finance company—and often could not get a loan for a first mortgage to purchase a home or refinance an existing first mortgage.

The 1990s and the rise of the non-prime mortgage market

The rise of the non-prime mortgage market was triggered in large part by the development of a secondary market for non-prime loans in the mid- to late-1990s. The term "secondary market" refers to investors who purchase loans from the original lenders. This provides the lenders with much needed liquidity—the ability to sell the loans they have made so they can use their funds to make additional loans.

Initially, the non-prime lending market focused on the refinancing of the high-rate loans non-prime borrowers had received from finance companies. As the market developed, numerous new products became available to non-prime borrowers. This was due largely to various ways investors in the secondary market found to decrease the risk in investing in non-prime loans (called "credit enhancement").

As technology improved and underwriting tools became more sophisticated, lenders were able to assess the risk of different interest rates on individual loans, thus leading to greater "risk-based pricing." This broadened the range of prices and products offered to non-prime borrowers, tailoring them to the risk levels of individual borrowers.

1998—A Slowing

After a surge of growth in the 1990's, the non-prime market retreated somewhat toward the end of that decade. This was caused by a number of factors:

First, the non-prime loans made in earlier years performed more poorly than expected. This led many investors in the secondary market to either shy away from non-prime loans or to demand greater credit enhancement of non-prime loans.

Second, some court decisions and laws enacted and/or considered by some states created concern among investors in the secondary market that they might be held liable for the original lender's mistakes—even if the investors were not aware of them. Such potential "assignee liability" (discussed below in the "Terms and Issues" section) made investors unwilling to invest in loans that might expose them to liability for a lender's mistakes. Without a secondary market in which to sell loans that might result in assignee liability, most lenders stopped making loans subject to such laws.

Third, changes in the financial markets resulted in a "flight to quality" for investors, resulting in a steep decline in the desire to hold securities backed by non-prime loans. As a result of these and other factors, many of the top producing non-prime lending companies experienced severe financial difficulties and went out of business.

The current non-prime mortgage market

Historically low interest rates and rising home values have combined to fuel a steady expansion of non-prime lending in recent years, which is thought to be 20-25% of the mortgage market today by dollar volume. A substantial volume of these loans are "purchase money" loans (i.e., loans used to purchase a home). An even greater volume of these loans are debt consolidation loans—loans designed to allow borrowers to consolidate debts, including credit card debts, many of which may have very high interest rates, into one loan with a lower monthly payment and lower interest rates. As mainstream lenders continue to enter the non-prime market, pricing has become increasingly competitive.

A very large fraction of the current non-prime market is considered "Alt-A"—borrowers with "prime" credit histories but who want loans with high loan-to-value ratios, high debt-to-income ratios for higher property cost markets like California, reduced documentation requirements, or other single deviations from prime lending criteria. Lenders have developed numerous new products to meet the needs of these consumers.

At the same time, investors have been unhappy with the performance of the lower credit quality mortgages and as a result, many lenders have tightened their underwriting standards to limit their production of such loans.

As with any business cycle, the non-prime market is undergoing somewhat of a market correction currently. As home values have stabilized and interest rates have risen, the demand for mortgages generally has slowed. The quest to maintain production levels has led some brokers to abuse some non-prime products such as stated income loans (e.g., instead of using a stated income loan for a small business owner that did not wish to share her income tax return with her lender, the broker puts a borrower who was rejected by one lender for a documented loan based on insufficient income into a stated income loan at a falsified income level). The resulting uptick in delinquencies (although still not outside of historical limits) has led to more loan repurchase demands from investors. (Investors typically can require lenders to repurchase loans that have an early payment default, because of non-compliance with underwriting standards, suspected fraud, or other discrepancy.) This in turn has led to the report of several non-prime lenders closing their doors and a resulting re-tightening of underwriting standards and processes.

BENEFITS TO CONSUMERS

Non-prime lending has had several important benefits to consumers, especially those who would not otherwise be able to qualify for mortgage credit. "Risk-based pricing" has allowed a vast expansion in the variety of consumers who qualify for mortgage credit. Many consumers who want to buy a home or who want to gain access to the equity of the home they already own can do so, where they may not have been able to do so otherwise. Although many advocates decry "debt consolidation" loans, such consolidations often reduce the interest rate the consumer is paying by half or more. The development of a robust secondary market also has lowered dramatically the price of credit for non-prime borrowers. Additionally, the creation of a non-prime lending market resulted in many new products that have addressed the special needs of consumers—needs that were not met by traditional Fannie/Freddie loan products.

NON-PRIME VERSUS "PREDATORY" LENDING

Some critics of non-prime lending have attempted to equate non-prime lending with "predatory lending." However, it is now widely acknowledged that there is a clear difference between the two. While no universally accepted definition of "predatory lending" exists, it clearly is a term used to cast certain lending practices in a negative light. This term might rightly be applied to practices designed to cheat consumers out of their money and homes, but it is not properly applied to the vast majority of non-prime lending transactions. Prices of non-prime mortgage loan products are usually higher, reflecting the greater risk taken by the lender in lending to non-prime borrowers and the higher costs that non-prime lenders face in originating such loans. Non-prime lending provides important access to mortgage credit to many consumers—consumers who would not be able to buy new homes or tap into the equity existing in their homes otherwise.

It is also important to remember that no matter what a lender does, some borrowers—whether non-prime or prime—will find themselves in a position where they are unable to make their loan payments. This has been shown to occur most often when a borrower suffers an unexpected job loss, medical emergency, or other major life change, such as a divorce. Because a failed loan transaction is costly to all concerned, lenders and mortgage servicers (those who are responsible for collecting the borrower's payments and forwarding them to the investor) have developed programs to help borrowers through financial difficulty where possible, including encouraging customers to work with HUD-approved credit counseling agencies and offering flexible repayment plans. If the borrower still cannot repay the loan, efforts are made to allow the borrower to sell the house on his or her own to avoid the negative consequences of a foreclosure on the borrower's credit report. While their circumstances of these borrowers certainly are regrettable, they represent a small minority of borrowers. The large majority of non-prime borrowers are able to make their loan payments. The misfortunes of a few, as lamentable as they are, do not justify branding non-prime lending as "predatory", especially in light of the benefits it provides consumers generally.

RULES MAY DIFFER FOR DIFFERENT PLAYERS AND DIFFERENT PRODUCTS

Not all non-prime lending programs are subject to the same rules. All lenders are subject to the panoply of federal laws that apply to mortgage lending, including the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Fair Credit Reporting Act, the Truth in Lending Act, and the Home Ownership Equity Protection Act. This last law, known as "HOEPA," which was enacted as an amendment to the Truth in Lending Act, provides additional restrictions and disclosures for non-prime loans. It is triggered when the interest rate or points on a loan exceed certain thresholds.

Over 30 states and 10 localities have enacted their own higher-cost lending laws and regulations. These laws generally apply to state-licensed lenders and mortgage brokers. Federally-chartered lenders (e.g., national banks, federal savings banks, etc.) operate under federal laws that generally preempt most of these state laws relating to lending. In return, these lenders are subject to comprehensive examination and supervision by their federal regulator, including for practices that could be deemed unfair or deceptive. As noted, the issue of "assignee liability," that is, whether the purchaser of a loan may be held responsible for the law violations of the original lender, significantly affects the market for these loans. Because this liability for state law violations committed by a state-licensed originator, even if the loan purchaser is a federally chartered entity, federal banks investing in these loans still have to be concerned about these state laws.

Also, some federal and state laws apply only to certain types of loans. For example, the laws applicable to a non-prime loan may vary if the loan is a fixed-rate versus and adjustable-rate loan, if it is first lien versus a junior lien loan, if it is a purchase money loan (i.e., one used to buy a home) versus a non-purchase money loan (i.e., a refinancing), etc. Most recently, a good example of product-specific regulation is the guidance issued by the federal banking agencies for so-called "nontraditional" mortgages, i.e., loans that involve the deferral of interest or principal payments.

TERMS AND ISSUES

When discussing non-prime lending, several terms and issues are generally included in the discussions. These are discussed, in alphabetical order, below.

- *Acceleration/Call Provisions.* Almost all loan agreements, whether for prime or non-prime loans, give the lender (or, if the loan has been sold, the investor) the right to demand immediate full payment of the loan when a borrower defaults on a loan. This is called "acceleration" of the loan, and such a provision is an acceleration or "call" provision.

  When a borrower defaults on a loan, the lender or investor reasonably may doubt its ability to obtain the amount owed. Since the risk of loss rests on the lender or investor, the ability to accelerate gives the lender or investor one last chance to recover the amount lent—and gives the borrower one last chance to pay off the loan and avoid foreclosure.

- *Aggressive Marketing.* The manner in which a mortgage product is marketed to a prospective non-prime borrower is sometimes at the center of an allegation of predatory lending. The Federal Deposit Insurance Corporation (FDIC) has indicated that engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower is a key element in predatory lending. Misleading, deceptive, fraudulent advertising is both unethical and unlawful. All the states have laws prohibiting unfair and deceptive acts and practices, and many states have additional, specific prohibitions on deceptive mortgage advertisements. The Federal Trade Commission Act prohibits such practices at the federal level. That Act is enforced by both the Federal Trade Commission and the federal banking agencies. The Truth in Lending Act has detailed rules governing the content of advertisements for credit, which apply to all creditors, including non-prime lenders. A mortgage loan is not a simple transaction. It can involve various features, some of which may be beneficial to a particular borrower, some of which would not. Educating borrowers to enable them to understand and easily compare competing non-prime products, indeed all mortgage products, is a critical component to any program to address predatory lending.

- *Arbitration.* Arbitration is a way to resolve disputes outside of court. Arbitration has been shown to be a fair, fast and affordable way for consumers to resolve disputes with companies. While some claim that arbitration is not fair to consumers, numerous studies have shown that consumers fare well in arbitration. In arbitration, consumers win more often, win a higher amount of the amount they demand, and resolve the dispute much faster than in court. Arbitration also allows consumers to bring claims that are too small for any lawyer to take.

  Opponents of arbitration often refer to arbitration as "mandatory arbitration." While the arbitration agreement is part of the larger loan agreement, arbitration is no more mandatory than any other parts of the agreement. Arbitration is not less fair simply because the consumer and the lender agreed in advance to resolve any disputes through arbitration.

- *Assignee Liability.* An investor that buys a mortgage loan is also called an "assignee." Under the federal HOEPA and many state high-cost home loan laws, an investor in certain circumstances may be liable for mistakes made by the original lender—even if the investor did not know about the mistake. This liability is known as "assignee liability."

  Supporters of assignee liability argue that it is necessary to ensure that lenders comply with federal and state high-cost home loan laws. In practice, however, the result of assignee liability is that investors avoid loans for which they may be exposed to assignee liability, particularly for more than their investment in the loan. Consequently, lenders do not make loans covered by high-cost home loan laws. Thus, as a practical matter, the high-cost home loan laws effectively become usury limits.

- *Balloon Loans.* A "balloon loan" is a loan that has lower monthly payments followed by a larger "balloon" payment due at the end of the loan term. Balloon loans serve an important purpose in the non-prime mortgage market. Lenders may be reluctant to extend long-term loans to certain borrowers due to credit risk or other circumstances specific to the borrower. However, if a borrower were required to repay fully a mortgage loan over a shorter period, the monthly payments may be greater than the borrower could afford. For example, the monthly payments required to repay fully a $200,000 mortgage loan in 10 years would be much higher than those required to repay the loan in 30 years. Few borrowers, if any, would be able to afford monthly payments that would fully repay a loan in a short period of time. Thus, the parties may structure a balloon loan where the monthly payments are set as if they were to be spread over 30 years, but with an actual loan term of 10 years, at the end of which the balloon payment would be due.

A balloon loan allows the customer to make much smaller monthly payments for the term of the loan. Thus, during the term of the loan the borrower is able to build equity in the home and improve his or her credit in a way the borrower can afford. As a result, even in those cases where the borrower may be unable to make the balloon payment, the borrower is in a better position to refinance or to cash out equity. In this way, balloon loans aid non-prime borrowers in achieving homeownership, in repairing their credit rating, and in structuring a loan to meet their specific circumstances.

- *Fees and Charges.* As with prime loans, non-prime loans involve a variety of settlement services that are necessary to close the loan, including an appraisal, a credit report, application and loan processing, underwriting, title search and title insurance, survey, notary services, closing services, etc. In addition to these fees are the fees paid to the mortgage broker for its services, the loan origination fee for the lender's origination services, and "points" that may be paid to secure a particular interest rate. Generally, a borrower is able to "buy down" an interest rate by paying to the lender upfront cash in the form of "points." Non-prime loans often have higher origination fees and points than prime loans because they generally involve a higher level of effort to originate (as well as service) and they generally pay off sooner. Thus, the points paid upfront are often a key component to an investor's return on the loan because the length of time it will receive monthly interest payments is less.

  As competition has increased in the non-prime market, prices have come down. Again, educating borrowers to shop and compare among competing loan offerings among lenders is the best way to obtain the most appropriate, lowest-cost loan. Borrowers, particularly, should be aware of the impact of financing points and fees into their loan amount. While this may be appropriate in certain instances, they should understand the cost of this option, and its effect on the equity they have in their homes.

- *Flipping.* "Flipping" is a term used to refer to an alleged practice of repeatedly refinancing loans without providing any benefit to the borrower. In such a case, the lender profits from the fees from the new loan, while the borrower is left in no better, and perhaps worse, condition.

  While there is widespread agreement that true flipping is an unethical lending practice, any effort to prevent flipping must not prevent consumers from refinancing for legitimate purposes. For many consumers, much of their wealth exists in the form of home equity. When a need for additional cash arises, consumers should not be prevented from drawing upon that equity simply because they had recently obtained or refinanced a loan.

- *High-Cost Home Loans.* "High-cost home loan" and other similar terms refer to loans that are covered by a state high-cost home loan statute. Such loans are covered because they exceed one or more of the thresholds in such laws. (The federal HOEPA contains similar thresholds, but does not use this term.)

- *HMDA*. HMDA is the acronym for the federal Home Mortgage Disclosure Act. HMDA requires lenders to disclose certain facts about mortgage loans to the federal government. Although HMDA was originally enacted to track housing capital flows into urban neighborhoods, HMDA data is now used to monitor lending patterns in order to prevent discrimination in mortgage lending. HMDA has received a great deal of attention in recent months because HMDA disclosures now include information on the price of loans above a certain threshold, that is designed to show the pricing in the non-prime market.

  While HMDA provides many facts regarding a mortgage loan, such as the loan amount, the property location, the borrower's race, sex and ethnicity, and the borrower's income, it does not include information regarding creditworthiness and other determinants of the loan price. Thus, while HMDA information is useful in showing overall patterns of lending, which is used by regulators, it does not and can not establish discrimination. Without information about a consumer's creditworthiness, which is obtained by examining individual credit files, it is impossible to know whether any lending pattern is the result of discrimination, or whether it simply represents a lender's neutral and nondiscriminatory application of valid, established and accepted credit standards.

- *HOEPA*. As noted above, HOEPA is the acronym for the federal Home Ownership and Equity Protection Act. HOEPA imposes additional requirements on loans that exceed certain thresholds. (The thresholds are discussed below.) Additionally, HOEPA imposes assignee liability on investors in certain circumstances.

- *Introductory or "Teaser" Rates*. To make a loan more attractive to borrowers, some lenders offer loans that start with a low rate which then increases after a short time (e.g., 1 year). The low, short-term rate is called an introductory or "teaser" rate. While such rates provide obvious benefits to borrowers, some consumer advocates have argued that consumers do not understand that the low introductory rate is only temporary.

  This argument relies on an assumption that consumers are less intelligent and less sophisticated than they really are. There is no evidence that any significant number of consumers are confused by introductory rates. In fact, it is the experience of lenders that consumers know exactly (usually to the day) how long introductory rates will last.

- *Loan-to-Value Ratio*. A loan-to-value ratio (or "LTV") is the comparison of the total loan amount to the total value of the collateral property. For example, if a lender makes an $80,000 loan secured by a house worth $100,000, the loan-to-value ratio is 80.

- *Negative Amortization*. The term "amortization" refers to a loan being paid down over time. "Negative amortization" refers to a situation where monthly payments are not enough to cover the amount of interest accrued, so that the total amount owed increases notwithstanding the monthly payments.

While negative amortization should not be the rule, it does serve an important purpose in mortgage lending, and non-prime mortgage lending in particular. If a borrower encounters a financial hardship (e.g., loss of employment, health care expenses, etc.), the borrower may be unable to make his or her regular monthly payments. Allowing the borrower to make a smaller payment allows the borrower to avoid losing his or her home. While the total amount of indebtedness may increase for a period, many borrowers would prefer to remain in their homes and address the greater debt once they have had a chance to get back on their feet. Loans that provide for flexible monthly payments, including those where the monthly payment may result in negative amortization, thus serve consumers in important ways.

- *Prepayment Penalties.* When a lender sells loans to an investor on the secondary market, the price the investor pays is greatly influenced by the time the investor believes the borrower will continue to make payments on the loan. If a loan is repaid quickly (for example, through a refinancing), the investor will make much less money on the loan, and may even lose money. Thus, the investor is willing to pay more for loans where the investor believes payments will continue for a longer period. When investors are willing to pay more, lenders can charge borrowers less money and still make an acceptable profit on the loan.

  By creating an incentive for borrowers to keep a loan for a longer time, prepayment penalties make loans more attractive to investors—and, consequently, less expensive for borrowers. Because lenders can sell loans that contain prepayment penalties to investors for higher amounts, they are able to offer these loans to consumers more cheaply. Thus, prepayment penalties lower the cost of the loan for the borrower. If a borrower intends to stay in a house for at least 3 years (the typical time a prepayment penalty might be imposed) a borrower reasonably and understandably could conclude that agreeing to a prepayment penalty in exchange for a lower loan price makes good sense. Many lenders offer borrowers the option to take a loan without a prepayment penalty, although the no-prepayment penalty loan would be at a higher interest cost.

- *Repayment Ability.* Some consumer advocates have argued that lenders make loans to non-prime borrowers based only on the value of the collateral, not on the borrower's ability to repay the loan. This argument simply ignores the lender's true interest and motivation in making loans. The vast majority, if not all, lenders want the borrower to repay the loan. This is, after all, how the lenders make money. Moreover, no lender will long remain in business if it consistently sells loans into the secondary market that default. While the collateral in the house provides protection to the lender if the borrower defaults, the lender would much rather have regular payments than take possession of a house. Once in possession of a house, the lender must bear the expenses of maintaining and selling the house, usually at a lower price reflecting the forced sale, an expense and a headache lenders simply do not want. Because lenders are best served when the borrower repays the loan, the criteria used by lenders in making loans are designed to ensure that the borrower can, in fact, repay the loan. While a small minority of borrowers unfortunately turn out to be unable to repay their loans, few lenders (if any) make loans unless they believe the borrower will be able to do so.

- *Risk-Based Pricing*. "Risk-based pricing" is a term that refers to lenders basing the price of a loan product on the borrower's individual creditworthiness. The better the consumer's credit, the lower the price of the loan.

  Traditionally, lenders were not able to provide many different prices on loans. As a result, borrowers with good credit paid more than their risk warranted, and borrowers with worse credit paid less—if they could get credit at all. New technologies enabled lenders to tailor prices to individual consumers. Now, a consumer with good credit is rewarded with lower pricing, while a consumer with worse credit often can still obtain credit but will pay a higher amount because the customer is a worse credit risk.

  Stated Income. A "stated income" loan is a loan where the borrower affirms, but does not provide verifiable documentation of, the amount of income he or she earns. These loans are for the many prospective borrowers who have the income and credit capacity to afford a mortgage loan but lack the documentation to verify their income. Traditional underwriting standards require that an applicant provide documentation verifying that he or she actually earned the amount of income they are claiming in each of the prior two years. Self-employed persons often have difficulty with this requirement, as well as persons who may have received a recent raise in salary or who expect a sizable bonus that was not paid in the previous years. While lenders do not verify the amount of income stated, they do require the source of the income to be verified. For example, they generally require that the borrower have been in its current business or line of work for the past two years. Moreover, lenders have various ways of confirming, through external sources and online surveys, that the income stated is roughly consistent with the incomes generally earned in that type of occupation or business in that geographic area. Stated income loans carry a somewhat higher interest cost than full-documentation loans because of the perceived higher risk of not having verified income, even if the credit score of the borrower is acceptable.

- *Steering*. Some consumer advocates have alleged that some lenders harm unsophisticated borrowers by guiding those borrowers toward higher-priced loans, even if they may be able to afford a lower-priced prime loan. These allegations also have included a focus on the discriminatory steering of minority borrowers into such loans. This alleged practice is called "steering."

  While there is widespread agreement that true steering is unethical, efforts to prevent steering must take into account the different costs to lenders from operating different "channels." Lenders often have several different methods of making loans, called channels. For example, independent mortgage brokers are a common source of loans for lenders. This is known as the "wholesale" channel. Many lenders also have locations or branches where the lender makes loans directly to borrowers through its loan officers. Some also use the internet or call centers to market loans and accept applications from borrowers. Direct lending from lender-owned locations is referred to as a "retail" channel. Different channels have different operating costs and, as a result, loans made through different channels often are priced differently. If a borrower applies through a lender's retail channel, the borrower may not be offered the same price a borrower might be offered through a broker channel. Any efforts to curb steering should acknowledge the real-life differences in costs to lenders.

- *Tangible Net Benefit.* In trying to prevent "flipping" (discussed above), some consumer advocates have argued that certain refinancings be permitted only if the refinancing provides a "tangible net benefit" to the consumer.

  In practice, a "tangible net benefit" standard creates several serious problems. For example, many borrowers refinance to obtain benefits other than more favorable loan terms. For example, a borrower may refinance to obtain cash to put a child through school or to pay for health care expenses. While these are significant and meaningful benefits, they cannot be measured in terms of lower interest rates or lower monthly payments—in fact, the interest rate and monthly payment may be higher. Any analysis of the benefit to the customer must take such benefits into consideration.

  Additionally, a tangible net benefit standard puts lenders in the impossible position of having to determine when a borrower is benefited by a refinancing. Even when the benefit is a more favorable loan term, determining whether a loan benefits a consumer is very difficult. Is a consumer better off with a higher interest rate but lower monthly payment, or vice versa? When non-economic benefits—like paying for a child's education—are part of the equation, it is impossible for a lender to apply any objective criteria to determine whether the consumer has received a "net" benefit.

  The tangible net benefit standard also creates a dangerous moving target, even when only economic factors are considered. For example, at the time a consumer applies for a loan, he or she may want a lower monthly payment—even if that lower monthly payment is accompanied by a higher interest rate or a balloon payment. Both the consumer and lender may agree at that time that such a loan benefits the consumer. However, if the consumer later encounters financial set-backs (or simply wants to reap a windfall), the consumer might argue that he or she did not really get a benefit because the loan had a higher rate, balloon payment, etc. Lenders must not have such an impossibly unstable standard imposed on them.

- *Thresholds.* HOEPA and many state high-cost home loan laws apply only to loans that exceed certain thresholds. Generally, there are two types of thresholds either of which, if exceeded, will cause a loan to be subject to HOEPA or a state high-cost home loan law:

- The first is an interest rate threshold. If the interest rate on a loan exceeds a certain amount—usually defined as a number of percentage points above a certain index, such as the yield on Treasury securities—then the loan is a covered loan. For example, HOEPA provides that the interest rate threshold for certain first-lien loans is 8% over the Treasury yield.

- The second is a "points-and-fees" threshold. If the total points and fees exceed a certain percentage of the loan amount, then the loan is a covered loan. For example, HOEPA provides that the points-and-fees threshold for certain loans is 8% of the total loan amount.

A points-and-fees threshold creates two important issues: First, determining which charges are included in the "points and fees" can be very difficult, leading to compliance burdens for industry. Second, points and fees are more likely to exceed a threshold for smaller loans than for larger loans. Many loan costs are roughly the same whether the total loan amount is large or small. For example, an appraisal fee will be roughly the same whether the loan is for $1,000,000 or $10,000. Thus, for smaller loans it is more likely that small points and fees will exceed the threshold.

Because HOEPA and many state high-cost home loan laws also contain assignee liability provisions that apply to covered loans, it is difficult, if not impossible, for lenders to sell covered loans into the secondary market. Thus, these thresholds function in practice as limits above which few lenders will make loans.

- *Yield Spread Premiums.* When lenders work with mortgage brokers, they provide the brokers with rate sheets showing the interest rates at which they will make and fund certain loans and the corresponding funding amount. For example, a lender's rate sheet may state that the lender will fund a loan bearing an interest rate of 7.0% at 100% of the loan's face value, known as "par", and a loan with an interest rate of 7.5% at 101% of the loan's face value. With this information, the mortgage broker will negotiate an interest rate with the borrower that meets both its and the borrower's purposes. For example, if the borrower does not want to pay any upfront fees to the mortgage broker, and the broker is willing to accept 1% of the loan amount for its services in the transaction, it will offer the borrower a 7.5% rate loan. If the loan is approved and made, the lender will fund the loan at 101%, with 100% of the loan amount going to the borrower and the additional 1% going to the mortgage broker as compensation for its services. This compensation is called a "yield spread premium" or "YSP".

  The Real Estate Settlement Procedures Act regulates yield spread premiums. First, the broker may not receive compensation for its services, including a YSP, that is in excess of the amount that is reasonably related to the value of those services generally in the market. Second, both the mortgage broker and lender are required to disclose the YSP to the borrower. An estimate of the YSP must be provided within three days after application, and the actual amount of the YSP must be provided at closing.

The U.S. Department of Housing and Urban Development has acknowledged that yield spread premiums can be a flexible and effective way to structure the broker's compensation in a manner that benefits the borrower. Moreover, a lender's willingness to pay yield spread premiums is essential to its ability to attract mortgage brokers to sell the lender's products. If a lender will not pay yield spread premiums, brokers will market the products of other lenders who will. Many lenders have gone beyond the YSP disclosure required by RESPA to provide a more detailed disclosure of how YSPs are used and how they fit in to the total compensation of the mortgage broker.

FURTHER INFORMATION

This primer discusses briefly non-prime mortgage lending and many of the issues surrounding it. For further information on non-prime mortgage lending and any of the issues discussed above, please contact Anne Canfield, Executive Director of the Consumer Mortgage Coalition at 202-544-3550.

TESTIMONY SUBMITTED FEBRUARY 26, 2007 BY THE:

American Financial Services Association

TO THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

"Preserving the American Dream: Predatory Lending Practices and Home Foreclosures"

The American Financial Services Association (AFSA) appreciates the opportunity to submit its written testimony concerning predatory lending practices and home foreclosures to the Senate Committee on Banking, Housing, and Urban Affairs. AFSA is the national trade association for the consumer credit and finance industry. Founded in 1916, AFSA has a broad membership, ranging from large national financial services firms to single office, independently owned consumer finance companies.

Although it is diverse, AFSA's membership is united by its main goal of serving the credit needs of consumers and businesses. The association endeavors to help consumers understand the mortgage lending process, product options available to them and the terms and conditions associated with the product they choose. Our members are committed to robust compliance with fair lending principles and practices.

Home ownership is a key component of wealth building in our country. For most Americans, their home is the most valuable asset they own. In addition, the historic rise in home ownership has strengthened communities and bolstered our economy. AFSA is proud of the role that its members have played in expanding opportunities for more and more families to participate in the American dream of home ownership. Product innovation is the key that unlocks the door to homeownership.

Up until the 1980's, most lenders made only prime loans. Consequently, many consumers with any blemishes on their credit history were unable to buy a home. Even consumers with pristine credit were forced to meet fairly rigid, conventional lending standards and those that did still had limited lending options available to them.

In the 1990's, technology improved, underwriting tools became more sophisticated and more lenders began to employ risk-based pricing models. As such, these lenders were able to better assess the level of risk for individual loans. Lenders began to tailor loans to varying circumstances, allowing borrowers with the best credit to get the lowest price and riskier consumers to have access to credit products that previously were unobtainable.

In addition, mortgage innovation has enabled over five million additional Americans to purchase their own home and raise their standard of living along the way. In the fourth quarter of 2006, the U.S. Census Bureau reported that U.S. homeownership was at a near-record level of 68.9%, up from 65.4% from the same quarter in 1996—meaning approximately 9.7 million more people own homes today than in 1996. This has been possible because the industry has developed new products to meet different borrower needs, utilizes risk-based pricing and is able to distribute risk appropriately. Imposing limitations on these products or on risk-based pricing will serve only to decrease the availability and affordability of mortgage credit, and undoubtedly will have a negative impact on homeownership rates. Such limitations will harm, not preserve, the American Dream.

AFSA member companies are in the business of extending credit to consumers who have the ability to repay their loans. Lenders determine a borrower's ability to repay based upon sound underwriting criteria. Yet despite the best calculations, some borrowers will have trouble making their payments and may find themselves in foreclosure. Since this a result that AFSA member companies want to avoid, they have adopted a standard in favor of working with delinquent borrowers to restore their ability to repay, reserving foreclosure as a measure of last resort.

While higher than anyone would like, overall foreclosure rates (about 1% nationally for all loans), are within historical norms. The mortgage lending market is adjusting – and will continue to adjust – to the recent rise in non-prime delinquencies, as it has in prior cycles.

The data from lenders continues to show that foreclosures are largely driven by changes in borrowers' personal situations such as: job loss, illness, divorce or death and not by product selection. Yet some would have the Committee address rising foreclosure rates by employing measures that effectively cut off innovative mortgage products offering the flexibility to address borrowers' specific financial needs. This approach is especially counterproductive for those families working to repair their credit or avoid delinquency. Therefore, AFSA is eager to work with the Committee in a way that minimizes the incidence of foreclosure while fostering product innovation that makes access to credit fair and affordable.

AFSA recommends three measure to help the Committee can achieve this goal.

1. GAO Study on Foreclosures
AFSA urges the Committee to have the Government Accountability Office (GAO) conduct an independent study of foreclosure rates to ensure that the Committee makes its policy determinations based on reliable data. Although we recognize that foreclosures have increased, we believe that recent Center for Responsible Lending foreclosure forecasts are grossly exaggerated. The industry's data shows that the vast majority of delinquencies and foreclosures are not due to loan terms or products, but rather the same factors that have led to delinquencies and foreclosures historically: job losses, divorce, and medical problems.

What's more, it's important to recognize that foreclosures can be measured by three different ways:

- Foreclosure Starts - a percentage of outstanding mortgages on which foreclosure proceedings **are started** during a particular time period, usually a calendar quarter.

- Foreclosure Inventory - a percentage of outstanding mortgages for which foreclosure proceedings **are pending** during a particular time period, usually a calendar quarter.

- Foreclosure Completions - a percentage of outstanding mortgages on which foreclosure proceedings **are completed** -- i.e., house is sold and consumer not longer owns it -- as of the end of a calendar quarter.

Conclusions about foreclosures rates can vary dramatically, depending upon which measurement rate is used. Though all of these measures indicate foreclosure proceedings, only the last category – Foreclosure Completions -- can indicate a loss of homeownership and its associated cost.

2. Public Service Advertising Campaign
AFSA recommends that the Committee authorize the U.S. Financial Literacy Education Commission (FLEC) or individual federal regulators to implement an ongoing, nationwide public service advertising campaign that encourages consumers to understand the terms and conditions of their mortgage loans before signing on the dotted line.

3. National Standards Legislation
AFSA urges the Committee to enact strong uniform national standards that avoid a patchwork of state requirements. At the heart of these standards should be simplified, understandable disclosure of key information about the loan that would enable consumers to better understand their credit obligations and comparison shop. Most accounts of abusive lending practices involve instances where the borrower was either confused or deliberately misled about key features of the loan. If the borrower receives a clear disclosure of these key features early in the transaction, it will be more difficult for an abusive lender or broker to misrepresent the terms of the loan and the borrower will have time to seek financing from other sources if the terms are unfavorable. In addition to transparency, AFSA urges the Committee to enact a standard whereby mortgage credit is extended only to customers who have an ability to repay their loan. This standard must be based on sound and objective underwriting criteria.

Finally, it's worth mention consumer education, which we believe is key. AFSA and its members remain committed to consumer education as the best way to minimize the default and foreclosure rates. AFSA's Education Foundation has developed *MoneySKILL*®, a state-of-the-art online curriculum for high school students that includes modules on responsibly managing credit obligations associated with mortgage and auto loans, as well as credit cards. Teachers have registered to utilize *MoneySKILL* ® in all 50 states and in 20 foreign countries.

AFSA shares the Committee's concern about predatory practices not only because they are injurious to individual homeowners, but also because they undermine the truly beneficial products and services that have allowed the dream of homeownership to become a reality for so many. We reject abusive practices and stand ready to work with the Committee to develop solutions, enhance existing fair lending provisions to root out bad actors and expand home ownership opportunities.

In closing, both borrowers and lenders benefit when lenders have the ability to offer a wide range of financial options -- and borrowers have the freedom to choose from them. In looking at possible approaches to abusive lending, we ask that the Committee pursue those that allow consumers to decide for themselves whether a loan is right for them.

Again, AFSA appreciates the opportunity to submit its testimony on issues relating to so-called "predatory" lending and foreclosures.

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STATEMENT OF LENDERS ONE/
NATIONAL ALLIANCE OF INDEPENDENT MORTGAGE BANKERS

Scott Stern, CEO of Lenders One
Chair, NAIMB

SENATE BANKING COMMITTEE, FEBRUARY 7, 2007
HEARING: "PRESERVING THE AMERICAN DREAM: PREDATORY LENDING PRACTICES AND HOME FORECLOSURES"

The National Alliance of Independent Mortgage Bankers (NAIMB) is the voice of the independent mortgage lender on regulation, legislation and government activity. The group was founded by Lenders One, a member owned cooperative of the nation's top 100 independent mortgage bankers. The member companies of Lenders One originate over $40 billion in mortgage loans annually, collectively comprising the nation's 9th largest mortgage originator. Our members constitute the nation's largest alliance of independent mortgage bankers, representing over 6000 employees serving every state.

During the past five years, the mortgage market has undergone substantial change. As home price appreciation accelerated, mortgage lenders responded with creative products to meet the challenge of qualifying borrowers for a home loan. The market for non-traditional mortgages has expanded significantly, from just 2% of originations in 2000 to over 30% in 2005. Similarly, non-prime lending has increased from 5% of the market to over 20%. For the vast majority of borrowers, these loan products have successfully enabled the borrower to successfully purchase and stay in a home.

However, defaults and foreclosures are now on the rise for some products. Congress and the mortgage industry must grapple with some difficult questions:

- To what degree is the emerging rate of delinquencies and defaults tied to unpredictable life changes (divorce, job loss) versus payment shock or unsuitable loan terms?

- What responsibility does a lender have to ensure the borrower's ability to repay a loan?

- In what circumstances do loan products, or combination of lending practices, present unacceptable risks to the borrower?

- How can Congress ensure a level playing field so that regulatory burdens are uniform for all lenders?

As Congress prepares to debate these questions, we think some key principles can form the basis for consensus.

- ***In the increasingly complex world of mortgage loan choices, not every consumer can independently evaluate whether a particular mortgage product is suitable to their circumstances.*** While most consumers appreciate their financial situation and understand the consequences of specific mortgage loan products, there are also many vulnerable consumers who lack financial sophistication.

- ***Lenders have an interest in ensuring that a borrower has a reasonable expectation of being able to meet loan payments.*** Reputable lenders have nothing to gain by making a loan that a borrower cannot repay. (Lenders must generally "buyback" a failed loan from an investor, and take the loss on their own books).

- ***If Congress decides to recognize lending standards in federal law, these standards must uniformly apply to all mortgage lenders, whether federal or state regulated.*** Independent mortgage bankers already meet state lending standards which in most cases are more stringent than federal rules. This has created an uneven regulatory burden for mortgage lenders.

- ***Borrowers should be covered by the same consumer protection standards, regardless of who regulates the lender they visit.***

The 2/28 Mortgage Product

Recently, particular concern has been raised about the so called 2/28 mortgage product, and whether this loan is inherently risky for a borrower.

Any mortgage product can be a "bad" mortgage product if the terms expose a borrower to significant financial risk.

The 2/28 mortgage product can be especially risky given that the terms of the program include:

--a short fixed rate period,
--an artifically lower start rate (a "teaser rate")
--a pre-payment penalty
--a significant interest rate adjustment.

Borrowers will typically qualify for a mortgage based on the starting rate and starting loan balance. Assuming even a reasonable case, a 2/28 mortgage could expose a borrower to significant "payment shock." Payment shock is when a borrower's payment increases well in excess of their ability to pay.

Not every 2/28 loan is inappropriate for every borrower. Borrowers who have a strong expectation of an increase in income (a spouse going back to work, for example), or are using the loan as a cash management tool, might be perfectly suited to a 2/28. But for wage earner borrowers who expect only minimal increases in income over the loan term, certain product features could expose the borrower to significant financial risk. Consider this example in which the loan product has these features:

1. High start rate.
2. Large interest rate adjustments.
3. Interest rate floors.
4. A long pre-payment penalty period.

So for example, a start rate and floor of 9.99%, with 3% annual adjustments and an 8% lifetime cap with a prepayment penalty of five years could mean that a borrower's payment would adjust:

Year 3: 12.99%
Year 4: 15.99%
Year 5: 17.99%

If this loan includes a 5 year repayment penalty, the borrower will see dramatic payment shock before being able to refinance without penalty. If the borrower qualified at maximum debt to income ratios in Year 1, the likelihood of the borrower being able to repay this loan once rates increase is slim. For a borrower in that situation, there is a high risk of default and foreclosure.

The Challenge Ahead for the Mortgage Industry

We believe the real challenge for the mortgage industry going forward is how to accommodate borrowers who are locked into inappropriate loans and move them into more suitable loan products. Many of these borrowers are in these loan products because they did not qualify for conventional financing. Creating safer loan products for which these borrowers can qualify will require the joint efforts of Fannie Mae and Freddie Mac, private investors, mortgage originators, and consumer advocates. We believe that is the best way to reduce defaults and foreclosures, and ensure that borrowers stay in their homes. The member companies of Lenders One/National Alliance of Independent Mortgage Bankers are pledged to be active partners in meeting this challenge.