S. HRG. 110–1013

TURMOIL IN THE U.S. CREDIT MARKETS: THE GENESIS OF THE CURRENT ECONOMIC CRISIS

HEARING

BEFORE THE

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

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

THE CAUSES OF THE CURRENT FINANCIAL AND ECONOMIC CRISIS

THURSDAY, OCTOBER 16, 2008

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

50–415 WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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C O N T E N T S

THURSDAY, OCTOBER 16, 2008

WITNESSES

TURMOIL IN THE U.S. CREDIT MARKETS: THE GENESIS OF THE CURRENT ECONOMIC CRISIS

THURSDAY, OCTOBER 16, 2008

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

The Committee met at 10:42 a.m., in room SD–538, Dirksen 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.

Let me welcome everyone to the hearing this morning. I want to welcome my colleagues who are here. Senator Crapo, I welcome you and thank you very much for being here this morning. Senator Akaka, Senator, how are you this morning? Good to see you as well. And, Sherrod, thanks for being here this morning. Let me thank our witnesses as well.

What I am going to do, if we can here this morning, is to make an opening statement, turn to my colleagues for any opening comments they would like to have this morning, and then we will get to our witnesses. Any and all statements or supporting documents that you would like to have included in the record, we will certainly make it a part of the record.

Just so people can be aware, my intention over the coming weeks is to have a series of hearings and meetings—some of them more informal, some of them more formal—to do what we are doing today, obviously, to go back and examine how we arrived at the situation we are in today; but just as importantly—in fact, I would argue even more importantly—what do we need to do from here forward so as to minimize these problems from ever occurring again.

Second, we want to watch and we are going to monitor very carefully, of course, the rescue plan that was adopted several weeks ago. As I think all of you are aware, there are provisions in that bill that literally require almost hourly reporting, every 48 hours or so on various transactions that occur, and we want to watch very carefully following the auditing process that we wrote into the legislation with the GAO and the Inspector General as well. And so the Committee will be working at that almost on a daily basis.

Then, third, the issue of financial regulatory reform. Secretary Paulson a number of weeks ago now, months ago, submitted a proposal on regulatory financial reform, and we never got to having the hearings we wanted to have on that, frankly, over the summer because of events with the foreclosure crisis and more recently with the broader economic crisis.

But I would like over these coming weeks between now and the first of the year to have this Committee, both formally and informally, meet with knowledgeable people—and there are some at this very panel who could be of help in this regard—as to what the architecture and structures of our financial services system ought to look like in light of the changes that have obviously occurred, updating a system that in many instances actually dates back more than 80 years.

The world has obviously changed dramatically, as we are all painfully aware, and having an architecture and a structure that reflects the world we're in today is going to be a critical challenge.

This is not an easy task. It will require a lot of thought, and careful thought, about how you do this. But I thought it would be worthwhile to begin that process, and then with a new administration arriving on January 20th, to already have sort of an up-and-running effort that we could then work with the new administration, be it a McCain administration or an Obama administration, to move that process along rather than just wait until after January 20th to begin a process that I think will take some time, quite candidly, given the complexity involved, going back to the 1933 act and other provisions. And as I said, several of you on this panel here have a wealth of knowledge about those laws and how they work or do not work. So I may very well be calling on some of you to participate, either informally or more formally, in that conversation and discussion.

Today's hearing is entitled "Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis," and I want to share some opening comments if I can on this and, again, turn to Senator Crapo and then to others to share some thoughts as well, if they care to, before we turn to our witnesses.

This morning the Committee examines the genesis, as I said a moment ago, of the crisis in our credit markets. Such an examination is in keeping with this Committee's extensive work over the past 21 months to understand the implosion of the mortgage markets and how that implosion has infected the wider economy.

All told, this Committee has held 73 hearings and meetings since January of 2007 when I first became the Chairman of this Committee. No less than 31 of those hearings have addressed in one form or another the origins and nature of the current market turmoil. Today's meeting is essential to understand not only how we got here, but just as importantly—and I would argue even more importantly—where we as a nation need to go. Only if we undertake a thorough and complete postmortem examination of the corpus of this damaged economy will we have any chance to create a world where the mistakes of the past are less likely to be repeated and where all Americans will have a fair chance at achieving security and prosperity.

It is by now beyond dispute that the current conflagration threatening our economy started several years ago in what was then a relatively discreet corner of the credit markets known as subprime mortgage lending. The Chairman of the Federal Reserve, Ben Bernanke, and Treasury Secretary Hank Paulson and many other respected individuals have all agreed on that fact. Mortgage market participants, from brokers to lenders to investment banks to credit rating agencies formed an unholy alliance conceived in greed and dedicated to exploiting millions of unsuspecting, hard-working American families seeking to own or refinance their homes. Relying on two faulty assumptions that housing prices would continue to rise maybe forever and that new financial instruments would allow them to shift the risk to others, these market participants flouted the fundamentals of prudent lending.

Certainly some borrowers themselves sought unjust enrichment in the process. They deserve neither our sympathy nor our assistance. But the millions of American homebuyers who today face foreclosure and financial ruination, the vast majority were victims, not perpetrators, of what will be remembered as the financial crime of the century. Indeed, the misdeeds of a few have robbed nearly every American. Whether they suffer from the loss of a home, retirement security, a job, or access to credit, Americans are reeling from the credit crisis.

Sadly, in my view, this crisis was entirely preventable. It is clear to me that greed and avarice overcame sound judgment in the marketplace, causing some very smart people to act in very stupid ways. But what makes this scandal different from others is the abject failure of regulators to adequately police the markets. Regulators exist to check the tendency to excess of the regulated. They are supposed to step in to maintain transparency, competition, and fairness in our economy. In this case, though, our Nation's financial regulators willfully ignored abuses taking place on their beat, choosing to embrace the same faulty assumptions that fueled the excessive risk taking in the marketplace. Instead of checking the tendency to excess, they permitted and in some ways even encouraged it. They abandoned sensible and appropriate regulation and supervision.

No one can say that the Nation's financial regulators were not aware of the threats posed by reckless subprime lending to homeowners, communities, and, indeed, the entire country. That threat had already been recognized by Congress. In fact, the Congress had already taken strong steps to neutralize it. In 1994, 14 years ago, then President Clinton signed into law the Home Owners and Equity Protection Act. This law required—let me repeat, required, mandated—the Federal Reserve Board as the Nation's chief financial regulator, and I quote, "to prohibit unfair, deceptive, and excessive acts and practices in the mortgage lending market."

Despite this direct requirement and mandate, the Federal Reserve Board under its previous leadership decided to simply ignore the law—not for days, not for weeks, not for months, but for years. Indeed, instead of enforcing the law by simply imposing the common-sense requirements that a mortgage loan be based on a borrower's ability to repay it, the Fed leadership actually encouraged riskier mortgage products to be introduced into the marketplace. And the public information on this point is massive.

The Fed's defiance of the law and encouragement of risky lending occurred even as the Fed's own officials warned that poor underwriting in the subprime mortgage market threatened homeownership and wealth accumulation. And it was incompatible with safe and sound lending practices. The Fed's defiance of the law and encouragement of risky lending occurred despite warnings issued by Members of Congress, I would add, including some of us who served on this Committee, that occurred despite warnings from respected economists and others that the Fed and its sister agencies were playing with fire.

It was only this year, 14 years after the enactment of the 1994 law, that the Fed finally published regulations to enforce the bill's provisions, the needed protections. By that time, of course, the proverbial horse was out of the barn. Trillions of dollars in subprime mortgages had already been brokered, lent, securitized, and blessed with unrealistic credit ratings. Millions of American homeowners faced foreclosure, nearly 10,000 a day in our country.

I spoke to a housing group from my State yesterday. There are 1,000 legal foreclosure proceedings every week in the State of Connecticut, and we have a foreclosure rate that is lower than the national average. A thousand cases a week in the courts in Connecticut in foreclosures. Tens of millions more are watching as their most valuable asset—their homes—decline in value. And the entire global financial marketplace has been polluted by toxic financial instruments backed by these subprime mortgages, which has caused a financial meltdown of unprecedented proportions and laid low our economy.

The evidence is overwhelming. This crisis is a direct consequence of years of regulatory failures by government officials. They ignored the law. They ignored the risks to homeowners. And they ignored the harm done to our economy. Despite this clear and unimpeachable evidence, there are still some who point fingers of blame to the discretion of Fannie Mae, Freddie Mac, and the Community Reinvestment Act. These critics are loud and they are shrill. They are also very wrong. It is no coincidence that they are some of the very same sources who were the greatest cheerleaders for the very deregulatory policies that created the financial crisis.

Let's look at the facts, or as Pat Moynihan used to say, "Everyone's entitled to their own opinions, but not their own facts."

On Fannie Mae and Freddie Mac, the wrong-headed critics say Fannie and Freddie lit the match of the subprime crisis. In fact, Fannie and Freddie lagged in the subprime market. They did not lead it. Between 2004 and 2006, the height of the subprime lending boom, Fannie and Freddie's share of subprime securitizations plummeted from 48 percent to 24 percent. The dominant players were not Fannie and Freddie, but the Wall Street firms and their other private sector partners: the mortgage brokers and the unregulated lenders.

In fact, in 2006, the height of the subprime boom, more than 84 percent of subprime mortgages were issued by private lenders. Private lenders. One of the reasons Fannie and Freddie lagged is because they were subject to tougher underwriting standards than those rogue private unregulated lenders. So it was the private sector not the Government or Government-sponsored enterprises that was behind the soaring subprime lending at the core of this crisis.

At the risk of stating the obvious, it is worth noting that at the height of the housing boom, the President and his supporters in and out of Government did nothing to criticize or stop predatory lending. They did nothing to support, much less advance, the legislation that some of us were working on to move in the Congress that would have cracked down on predatory lending.

Regarding the Community Reinvestment Act, the critics are also speaking in ignorance of the facts. The overwhelming majority of predatory subprime loans were made by lenders and brokers who were not, I repeat were not, subject to CRA. In 2006, for example, 24 of the top 25 subprime lenders were exempt—exempt—from the CRA. In fact, CRA lending is in no way responsible for the subprime crisis. CRA has been the law of the land for three decades. If it were responsible for creating a crisis, this crisis would have occurred decades ago.

The late Ned Gramlich, the former Fed Governor, put it well when he said that two-thirds of CRA loans did not have interest rates high enough to be considered subprime. Rather than being risky, lenders have found CRA loans to have low default rates. According to former Governor Gramlich, "Banks that have participated in CRA lending have found that this new lending is good business."

So people are entitled to their own opinions, as Pat Moynihan would say, but they are not entitled to their own facts. And Ronald Reagan once said, "Facts are stubborn things." Indeed, they are, as they should be in this regard.

Let me also say that I have learned over the years from this debacle that the American consumers, when all is said and done, remain the backbone of the American economy and deserve far better than they have been getting from too many people.

The lessons, obviously, of this crisis are already becoming clear to us. One of the central lessons is that never again should we permit the kind of systematic regulatory failures that allowed reckless lending practices to mushroom in the global credit crisis. Anther is that never again should we allow Federal financial regulators to treat consumer protection as a nuisance or of secondary importance to safety and soundness regulation.

If we have learned one thing from all of this, it is, as I said a moment ago, the American consumer, when all is said and done, remains the backbone of the American economy, that consumer protection and safe and sound operation of financial institutions are inextricably linked.

I look forward to hearing from our distinguished panel of witnesses and from my colleagues this morning as we go back and look at what occurred here and the ideas that can be put forward as to how do we minimize these problems from ever occurring again.

Again, I thank the witnesses very much and my colleagues for interrupting their time back in their respective States and districts to be here this morning to participate in the hearing.

With that, Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. Our financial markets and the economic crisis that we face today represent a very serious and a real threat, and we need to make sure that we are very clear about what the sequence of events were that occurred and what choices were made to place us in this catastrophic state of affairs. I agree that we have got to figure out how we got here so that we can correctly and properly address it.

I was pleased to hear that you intend to pay some very specific attention not only to oversight of the implementation of the recovery plan that Congress passed, but also to the need for regulatory reform and your mention of the blueprint that Secretary Paulson put out.

As you know, I am one who has been very involved in regulatory reform and modernization over the past few years, and I have some pretty strong opinions about how we need to approach establishing our regulatory system in this country. And I have noted in the testimony of some of the witnesses an explanation and a recognition of the fact that our regulatory system, developed decades and decades ago, has not kept up with the state of the economy and the types of financial activities and financial products that we are now dealing with on a global basis in our economy. And because of that, I think there is a true need to address what regulatory structure this Nation should have for a whole host of different pieces and aspects of our financial system. I am going to be interested in the witnesses' testimony about that.

I personally think that we, collectively, the Congress, as we struggle with this, will probably end up with some very different opinions and points of view about how we should approach that. There will be some who want a much more extensive role for the regulators than others. But the bottom line is we need to figure out how we will move forward, and we need to establish a regulatory system that will allow capital to flow in our country and in the global economy, really, in a free and an efficient and a safe way. And I believe that there is a way for us to achieve that.

So I appreciate the fact that you have indicated that you are going to be paying some very close attention to that even before the next Congress starts, and I look forward to working with you in that evaluation.

Chairman DODD. Thank you very much. And, by the way, let me thank all of the Members of this Committee. Obviously, not all are here for all the obvious reasons. I mentioned that when I became Chairman of the Committee in January of 2007, the very first hearing we had were on the foreclosure crisis—in this very room, in fact, and Members will recall, because they participated in it, that we filled this room with stakeholders on the foreclosure crisis and asked them what they were going to do to have a plan of workouts for people facing foreclosure.

Senator Crapo has been a leader for years here on regulatory reform, and he deserves a lot of credit for thinking about it.

In 2006, in fact, when our friends in the minority today were in the majority, it was Senator Bunning and Senator Allard that had some of the very first hearings on the foreclosure crisis, and the record ought to reflect that as well. And I also want to thank Senator Shelby, the former Chairman of this Committee and now the Ranking Republican on the Committee. We never would have been able to pass that very important housing bill in July of this year without the cooperation of every Member of this Committee. We came out of this Committee on a vote of 19–2 on a matter that people did not think you could come together on, including GSE reform as well as modernization of FHA and a variety of other points.

And so I thank all Members of the Committee, and obviously the rescue package, Senator Bennett and Senator Corker particularly on this Committee were invaluable in helping put together that plan as Republican Members, not to in any way detract from the tremendous work being done by the majority Members of this Committee as well on that effort.

So I would like the 73 hearings that this Committee held over the last 21 months, almost a hearing a week, over a third of them on this subject matter alone that brings us here today, as well as the legislative work of the Committee. But I wanted the Members to know how much I appreciate the efforts this Committee has made over the last 21 months.

Chairman DODD. With that, let me turn to Senator Akaka for any opening comments you may have, and I will ask other Members, and we will turn to our witnesses.

STATEMENT OF SENATOR DANIEL AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman. Thank you for conducting this hearing today.

I am hopeful that this hearing will help clear up some misconceptions and help promote a greater understanding of the cause of this financial crisis as we work to reform the financial services regulatory structure. And I thank you for this opportunity, Mr. Chairman.

I want to express some of my thoughts thus far on what has been happening. The uninformed have blamed much of the current financial crisis on the Community Reinvestment Act. That is simply not true. The CRA has helped empower individuals in low-income communities by promoting access to mainstream financial services and investment. Instead of finding excuses to stop Federal efforts to expand across to mainstream financial services, we must do more. Low- and moderate-income working families are much better off utilizing mainstream financial service providers rather than unregulated or fringe financial service providers. Working families would have been better off obtaining mortgages from their local financial institutions instead of obtaining mortgages through independent peddlers such as Countrywide.

The majority of subprime mortgage lending was done by independent mortgage companies that are not subject to CRA requirements and lacked effective consumer protections. I have greatly appreciated the extraordinary leadership and judgment shown by the Chairman of the Federal Deposit Insurance Corporation, Sheila Bair, during her tenure. I also have highly valued Chairman Bair's efforts to promote financial literacy and address issues so important to working families. Under Chairman Bair's leadership, the FDIC is encouraging the development of affordable, small-dollar loans using CRA initiatives.

Working families are exploited by predatory lenders who often charge triple-digit interest rates. As access to legitimate credit tightens, more working families will be susceptible to unscrupulous lenders. We must encourage consumers to utilize the credit unions and banks for affordable small loans. Banks and credit unions have the ability to improve lives of working families by helping them save, invest, and borrow at affordable rates. Repealing or weakening the CRA would be a mistake. Low- and moderate-income families must have greater access to regulated mainstream financial institutions, not less.

Critics of the CRA seem to forget that it does not apply to investment banks. Investment banks bought securitized and sold subprime mortgages. The CRA does not apply to credit rating agencies. The CRA does not apply to the sale of derivatives or credit default swaps. These products have contributed significantly to the financial situation that we are in now.

The causes of this crisis are complex and cannot simply be blamed on the CRA. Instead of repealing the CRA, we must overhaul and strengthen the regulation of financial services to better protect consumers, protect markets ability, and empower the regulators to be more forward-looking. Instead of just reacting to a crisis, regulators must quickly adapt to the financial service innovations.

I thank the witnesses for appearing here today, and I look forward to their testimony, and thank you very much, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. I really, really appreciate your holding this hearing today and the work you have done for much of the last year and a half. I want to thank the witnesses for their public service and their terrific work to explain and cajole and do all the things that I know many of you do very well.

It seems like a lifetime, but it was only about a little over 3 weeks ago when we heard from Secretary Paulson and Chairman Bernanke and others about the need for the Federal Government to spend $700 billion to shore up our financial system. The interest in that hearing was extraordinary. People were stunned by the Paulson proposal, shocked that we had reached that point where such massive Government intervention was necessary. More than 40,000 very angry Ohioans e-mailed me, called me, stopped me on the street, sent letters. Five thousand of those simply, Mr. Chairman, asked for hearings, thought that they wanted—people want to know who is responsible for this financial mess. Was there simply incompetence and indifference? Or was there criminal activity? And people want us to figure out in these hearings leading up to—well, through the end of this year, beginning next year, want us to figure out a regulatory structure so this does not happen to the American people again.

With the passage of a few weeks, I think it is becoming clear why we needed to take action, although by no means was it then or now a popular decision. The credit crunch has begun to cost jobs. My State of Ohio just in less than a decade has lost some 200,000 manufacturing jobs alone. We cannot afford any more job loss. The impact on middle-class families and their retirement accounts and their savings has become clear to everybody who had the nerve to open their quarterly statements they got the first week of October.

The last thing that Toledo's Joe Wurzelbacher has to worry about is the tax rate he might pay if he is lucky to have a quarter-million-dollar profit in his new business. My guess is he needs to worry a lot more about how he is going to finance the purchase of that plumbing business and what his cash-flow will look like, so long as residential and commercial real estate markets are stalled the way that they are.

So while we have a better understanding of the impact of the credit crisis, I think the causes are still unclear to so many Americans. In part, this is because there are a number of contributing factors that added fuel to the fire of an extended period of time. It is also because of a deliberate campaign to mislead the American public. Here are three of my favorite examples.

No. 3, blame the Democrats. Fannie and Freddie were the problem, so the argument goes, and Democrats pushed them to make loans to risky people. Really?

I served in the House of Representatives from 1993 to 2006. I can assure everybody the Democrats were not calling the shots after 1995. One of the few occasions when there was bipartisan cooperation was in 2005, when my former colleague from Ohio, Representative Mike Oxley, worked with Democrats to pass bipartisan legislation to strengthen oversight of Fannie and Freddie, legislation which the Bush White House torpedoes.

No. 2, it's Jimmy Carter's fault. You would think there would be some sort of statute of limitations. Maybe after 30 years, we should stop blaming past Presidents. But somehow, as Senator Akaka mentioned, the Community Reinvestment Act of 1977 is at fault for all the underlying current mess. Apparently, it has been laying dormant like a cicada on sleeping pills, waiting, just waiting, to devour our financial markets.

But my No. 1 favorite falsehood is a campaign ad being aired on television sets across the country. Among the lies it packs into 30 seconds are these, and I quote: "Congressional liberals fought for risky subprime loans. Congressional liberals fought against more regulation, then the housing market collapsed, costing you billions."

Now, I know quite a few congressional liberals in both Houses. Some are actually friends of mine, Mr. Chairman. And I can tell you that these claims simply turn history on its head. Does the campaign airing this ad really think the American people are going to buy this nonsense?

I think sowing confusion and cynicism is their real goal. They should not be surprised at the harvest.

Thanks to today's hearing, no one need take my word for it. The witnesses we hear from this morning will give the American people a clear picture of who supported efforts to update and enforce our laws to protect investors and protect depositors and middle-class Americans, and who opposed these efforts. I look forward to their testimony.

I would be remiss, Mr. Chairman, if I didn't first thank Treasurer Rokakis of Cuyahoga County, the largest county in my State, the Cleveland area, for his efforts dating back many years. He, Cleveland Mayor Frank Jackson, and others have been fighting against not just predatory lenders in places like Maple Heights and Slavic Village and Rocky River, but also fighting State and Federal agencies that for most of this period have ranged from indifferent to hostile.

Thank you, Mr. Rokakis, and thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Casey.

STATEMENT OF SENATOR ROBERT P. CASEY

Senator CASEY. Mr. Chairman, thank you, and thanks for calling this hearing in the midst of a time period when most people are back, most Senators and most House Members are back in their States. It is important that we keep a focus on this.

I want to commend the Chairman and Members of this Committee and others, even those not on this Committee, for the work that has already gone into dealing with this horrific financial crisis that the country is living through. We are far from resolving it. There is still a long way to go, but I think we have seen a lot of effective leadership here in both parties, and I think we need more of that. And, Mr. Chairman, you were among the leaders of that, and we are grateful for that. I do not think anyone will fully appreciate that leadership until maybe many years from now, but we are grateful.

And we are grateful for the witnesses today and the testimony you will provide and the guidance you will give us.

I think that we can get lost in a lot of the detail, but one of the reasons we are all here today, maybe the only reason, the main reason, is that we are here to talk about the root cause of this problem, and that is, foreclosures, foreclosures, foreclosures. We cannot say it enough. And, frankly, there is not enough being done to meet the challenge that poses.

Fortunately, despite the campaign season we are in, despite the silly season, some of which Senator Brown just recounted—and, unfortunately, some of it is deliberately misleading, not just misleading and erroneous but deliberately so for political reasons. But, fortunately, a lot of the work that has been done in the Congress the last couple of weeks and months and a lot of the work done by this Committee has been free of that, fortunately, and I think that is a good sign. This Committee has been an ideologically free zone for the most part, and I think that is a good example.

But I think we have got to be honest about the origin of this. The origin of this was bad lending practices and bad lending by, frankly, people in the private market—private players in the marketplace that were often unregulated completely or in many cases not regulated enough.

So that is why we are here, and I am resisting the temptation to say more, because it is pretty maddening when you see what some people in this political season will say about the root causes of this—and I will say it again—deliberately misleading the American people. But I think most people can see through it.

I am sending a letter to Secretary Paulson today with some concerns that I have and some suggestions as well that—look, we all want to support efforts that have been made by Secretary Paulson and others. But I have to say it troubles me that the Treasury Department most recently has talked about committing $250 billion to a new effort that has arisen to provide help for banks, but Treasury has provided or suggested that we provide $250 billion without modifying a single loan. And I do not believe that is what Congress intended. So I think the Treasury Secretary has more work to do and a lot more explaining to do. And the story, today I guess it is, in the Wall Street Journal about FDIC Chairman Sheila Bair about her concerns about the same topic, about the lack of action on modifications and foreclosure prevention.

I think we need to see more urgency when it comes to loan modifications and getting this asset purchase program up and running, because I am hearing—and I am sure others are hearing this as well—from housing counselors in Pennsylvania that for the past 3 weeks, lenders who had previously worked with them are now refusing to return telephone calls. They do not know why since no one will talk to them anymore, but they suspect, as I do—and I think many suspect this—that banks are now holding back on modifying loans because they are waiting to see if they can sell them to Treasury first. And I think Treasury's lack of clarity is apparently causing banks and investors to sit and wait—the worst thing that could happen right now.

While we attempt to learn from the mistakes of the past, we need to learn from the mistakes of the recent past as well, and Treasury needs to move more quickly to fully describe their plan to the American people, and especially to players in the marketplace. The Treasury also needs to commit to modifying more mortgages and making banks modify more mortgages as well.

So we have a long way to go, and this hearing, I think, is a step in the right direction. It moves the ball down the field to understanding where we have been, where we are now, and where we need to go. But the last thing we need is a lot of blowhards who are throwing theories out and charges out in the political silly season to score political points. We do not need that. We do not need ideology, and we do not need politics. We need clear-headed thinking, and we need people that are committed to solving the problem and not scoring political points to get their base fired up for election day. That is not what we are doing here today, fortunately, but outside the walls of this hearing, there is a lot of it going on. We should condemn it, we should point it out, and make sure that those who are doing it have the bright light of scrutiny applied to their misleading tactics.

Thank you.

Chairman DODD. Thank you very much, Senator, and I want to just mention briefly as well, I think Senator Akaka did it as well. Sheila Bair, President Bush's appointee to be the Chair of the Federal Deposit Insurance Corporation, formerly—I do not know if Members are aware of this. She was Bob Dole's legal counsel for years here in the Senate. She has just done a remarkable job, and I want to join in the voices commending her and thanking her for the work that she has done.

I mentioned earlier about the work of this Committee. Senator Shelby and I have worked very closely together, as I have with all Members, and I try to call all Members of the Committee when we are doing things as well. And I want my colleagues to know that certainly Senator Shelby and I, even when we have disagreed, stay in very close touch with each other. And I want to thank Barney Frank on the House side, and Roy Blunt, a Republican. They were invaluable during the most recent effort to put together a package here of rescue.

So there are a lot of good people up here working very hard on a bipartisan basis to get things done, and too often that gets lost. It is not as newsworthy when things like that happen, but it is worth noting and mentioning, and I am glad the Senator from Pennsylvania did.

Senator Menendez.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Well, thank you, Mr. Chairman, for holding what I think is a very important hearing on the genesis of the current economic crisis. You know, it is said over the mantel of the Archives Building, "What is past is prologue." And I think that unless we come to understand what has happened here, we are destined to relive it again—something that I do not think any one of us wants to see.

So as we navigate through what are treacherous waters, I think it is pretty critical to understand how we veered off course and ended up in uncharted territory.

Now, there are some who say we need to close this chapter in our history and stop looking back, but to me that is like trying to diagnose a patient without looking at the medical records. We need to know what went wrong in order to prevent it from happening again.

One of the major things that I personally believe led us to the conditions in which we are today is the administration's repeated mantra of regulatory relief, and now relief from that ideology is what I think we need. The administration was entranced with a mentality that Wall Street can do no wrong, but the inherent flaw in this thinking is that Wall Street is run by human beings who, like anyone else, are capable of greed and bad decisions. They need to be regulated by our regulators. But instead of being the cop on the beat, they were asleep at the switch.

Time and time again, the administration turned an absolute blind eye to warning signs. For example, the Federal Reserve sat on authority to regulate predatory lending. Then the Securities and Exchange Commission took a hands-off approach on supervision. That net operating rule decision, one in which they unlocked billions of dollars that were there to cushion against the possibility of loans that might default, and then use the computer modeling of the banks themselves to determine what was risk and what was value is beyond—blows the imagination. This is delegating the regulatory responsibility. This is delegating the responsibility of being the cop on the beat to those who you are ultimately supposed to supervise. And in my mind, that did no good for the American people and the American taxpayers.

In March, Mr. Chairman, of 2007—I have repeated this several times because it was a warning sign then. At a hearing that you chaired in these very chambers, I said then before the administration witnesses that we were going to have a tsunami of foreclosures. The administration said that was an overexaggeration. I wish they had been right and I was wrong. The reality is that we have not even fully seen the crest of that tsunami.

And so the challenges were there early on, and the lack of the responsibility of regulators, I think, to regulate was just an incredible abdication of responsibility. And they took action only when the house of cards was falling apart.

So I look forward to our witnesses today, some of them who have some extraordinary experience in the fields that the regulators of today pursue, but they had those experiences in the past, and I look forward to hearing some of their views and commentaries.

Mr. Chairman, I appreciate your calling this hearing. I hope it is one in a series. I am not one to have a great degree of trust in an administration who got us into this mess to get us out of it as successfully as we all want to see, which means, again, oversight. And as we look at the rescue plan, I hope that you will consider at the appropriate time making sure that we have some oversight of what's going on in that rescue plan, because, you know, I want to make sure that, first of all, this funding that we are infusing into banks—which I think is a good idea. However, I also want to make sure that that infusion works its way into Main Street and does not just stay on Wall Street.

Mr. Chairman, I think we have not done anywhere near what we need to do on the question of foreclosures. I find it ironic that we can keep a CEO in their office, but we cannot keep a family in their home. And this is the core of the issue—as you have so aptly said many times, this is the core of the issue of what has brought us to the credit problems that we are having in the country, the financial problems we are having. And it seems to me we would want to keep families in their homes and make them performing assets versus nonperforming assets, and everybody wins at the end of the day, as do communities. But we have not done anywhere near—I do not get the sense that the Treasury Department has any real commitment to trying to keep more families in their homes.

And so I look forward to today's hearing, to the ones I hope you will continue to call in the future. But, above all, I hope that we will get in the next administration regulators who understand what their duty and obligation is, what their oath is. And at the end of the day, that oath is to protect the American people and its institutions so that, in fact, there is transparency, so that, in fact, there is honesty, so that, in fact, we know what the real value of assets are, so that we do not find ourselves in the set of circumstances we find ourselves today.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator. You may have just been walking in when I mentioned that our intention is, in fact, to have a series of hearings, either formal or informal, on both this issue and where we go from here specifically.

Second, I am monitoring very carefully, and with designated staff, on a daily basis because some of the reporting requirements are on a 48-hour basis of the rescue plan. And then, third, looking at—and Senator Crapo has talked about it as well for a long time, which will require a lot more work, both informally and formally, about the structure, the regulatory reform structure that we need to put in place, sooner rather than later, obviously, but to begin that work even now to be able to offer to the new administration coming in some good work being done over these weeks before we convene after January 20th. So I thank you for those observations.

In fairness, too, I should mention that Chairman Bernanke—we have spent a lot of time with him over the last couple of years, but the Fed finally did, in July, promulgate regulations dealing with the 1994 law, and I appreciate him doing that. He also did stuff on credit cards, which I appreciate as well. Now, I would do more, and I think we ought to codify what they have done by regulation. But I would want the record to reflect that we appreciate the fact that Chairman Bernanke has moved on these issues.

As I said earlier, the horse was out of the barn, in effect, when this happened, but, nonetheless, they have moved on those two fronts.

With that, let me turn to our panel of witnesses, and I thank them immensely. Someone who has dedicated a tremendous amount of his life to public service, Arthur Levitt, Arthur, we thank you immensely for coming back. You are a familiar figure in this room. During your 8 years as Chairman of the SEC, you were here on numerous occasions. We worked on a lot of issues over the years, so I thank you for coming back. You served as the 25th Chair of the Securities and Exchange Commission, the longest-serving Chairman of the Commission ever in its history. And I for one do not mind editorializing and saying you did a great job, in my view, over the years.

Before joining the Commission, Arthur Levitt served as the Chairman of the New York City Economic Development Corporation and Chairman of the American Stock Exchange, among many other things, but certainly very visible positions in those posts.

He is sitting next to another very significant and tremendously successful public servant, Gene Ludwig. Gene, we thank you for being here this morning. Mr. Ludwig is the Chief Executive Officer of the Promontory Financial Group. He is the former Comptroller of the Currency where he was responsible for supervising federally chartered commercial banks and Federal branches and agencies of foreign banks. Prior to founding Promontory, Mr. Ludwig served as the Vice Chairman and Senior Control Officer of Bankers Trust Corporation/Deutsche Bank. Earlier in his career, Mr. Ludwig was a partner in the law firm of Covington and Burling.

Next we will hear from the Honorable Jim Rokakis, who is Treasurer of Cuyahoga County. He has already been introduced in a sense by Senator Brown. Mr. Rokakis has served as the County Treasurer since 1997, and prior to this position, he served for 19 years on the Cleveland City Council. He has been recognized for his outstanding work in Cuyahoga County. In 2007, he received the NeighborWorks America Local Government Service Award, the Leadership in Social Justice Award from Greater Cleveland Community Shares, and was named the County Leader of the Year by American City and County Magazine. We welcome you here this morning.

And a good friend of mine whom I have known for many, many years, Marc Morial, who is President and CEO of the National Urban League, the Nation's largest and oldest civil rights and direct services organization. Mr. Morial joined the Urban League in 2003 where he was focused on a five-point empowerment agenda encompassing education and youth, economic empowerment, health and quality of civic life, engagement in civil rights and racial justice. Prior to joining the Urban League, Mr. Morial served for two terms as the mayor of New Orleans and was President of the U.S. Conference of Mayors and was a Louisiana State Senator. Marc, it is good to have you here before the Committee as well.

And, last, we are going to hear from Eric Stein. Eric, you are going to join us at one point. You are not walking out on me now, Eric?

Eric Stein serves as President for the Center for Community Self-Help and the Chief Operating Officer for Self-Help and its affiliates, Senior Vice President for the Center for Responsible Lending, a nonprofit affiliate of Self-Help dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. Mr. Stein is on the Community Development Advisory Council of the Federal Reserve Bank of Richmond, and prior to joining Self-Help, Mr. Stein was Executive Director of CASA, a nonprofit housing developer, in addition to working for Congressman David Price and the U.S. Fourth Circuit Court of Appeals Judge Sam Ervin III. So you have had a long career as well, and we thank you for being with us.

Arthur, we will begin with you this morning, and, again, thank you for being back before this Committee.

STATEMENT OF ARTHUR LEVITT, JR., SENIOR ADVISOR, THE CARLYLE GROUP, AND FORMER CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. LEVITT. Thank you, Chairman Dodd and Senator Crapo, for the opportunity to appear before the Committee at this momentous time in the life of our markets.

From where we stand at this moment in this deeply serious and destructive market crisis, we already know that there is plenty of blame to go around, but let me be clear about one point. We are here today not because of what happened this year or last, but because of at least two decades of societal and political adherence to a deregulatory approach to the explosive growth and expansion of America's major financial institutions.

Furthermore, it is now readily apparent that our regulatory system failed to adapt to important, dynamic, and potentially lethal new financial instruments as the storm clouds gathered.

The list of failures goes well beyond the Securities and Exchange Commission, but today I would like to focus my remarks on that agency.

Right now, the key problem plaguing our markets is a total breakdown in trust, in investor confidence, in every institution that we have.

Since 1934, a strong SEC—staffed by consummate professionals and led by independent-minded commissioners—has succeeded in maintaining investor confidence and helping to make our markets the envy of the world.

Unhappily, over the past few years, the SEC has not lived up to this storied history.

As the markets grew larger and more complex—in scope and in the products that they offered—the Commission simply failed to keep pace. As the markets needed more transparency, the SEC allowed opacity to reign. As an overheated market needed a strong referee to rein in dangerously risky behavior, the Commission too often remained on the sidelines.

As this Committee examines the record, I believe it will find a lack of transparency, a lack of enforcement, and a lack of resources all played key roles. Allow me to highlight a few instances of these problems.

After all the markets have undergone the past few weeks, we still do not know the full extent of the losses incurred by banks and other companies on mortgage-backed securities. A lack of information about where risk resides is keeping investors suspicious and out of the markets.

One of the biggest steps we can take to bring to light a fuller picture of companies' financial health would be to expand fair value accounting to cover all financial instruments—the securities positions and the loan commitments—of all financial institutions.

Yet in recent weeks, fair value accounting has been used as a scapegoat by the banking industry—the financial equivalent of shooting the messenger. If financial institutions were accurately marking the books, they would have seen the problems they are experiencing months in advance and could have made the necessary adjustments, and we might have diminished the current crisis.

As the markets grew more complex, there was also a failure of oversight to keep up with growing and risky parts of it. The recent revelations about the CSE program are a glaring example of this problem.

The last area where we have seen a deviation from decades of SEC history, tragically, has been the enforcement of the laws on the books.

In part, this is the result of a lack of adequate resources. Budget and staffing levels have not kept pace with inflation or financial innovation. And recent procedural changes at the Commission have led to a lessening of the imposition of corporate penalties against egregious wrongdoers, a reduction in the corporate penalty in terms of penalty numbers over the past year and a demoralizing of the enforcement staff undermining their efficacy.

Of course, resources alone will neither reinvigorate the SEC nor revive our markets.

For the past 75 years, the Commission has been the crown jewel of the financial regulatory infrastructure and the administrative agencies because its leadership from both political parties—Chairmen like Kennedy and Douglas at its founding, and Ruder, Breeden, and Donaldson in recent times—understood the importance of public pronouncements and signals sent to the market, signals that were far more important than any rule that was passed or regulation that may have been considered.

Recently, at critical moments and on critical issues, the SEC has been reactive at best or has shown no real willingness to stand up for investors. And it is these moments that weaken the power of the agency and investors' faith in the markets.

Looking forward, restoring trust in our markets will require rejuvenating the SEC. It is the only agency with the history, the experience, and specific mission to be the investor's advocate—a history earned under the chairmanship of individuals from both political parties. Losing that legacy would be devastating to our ability to regulate the markets and restore investor confidence.

And let me be clear: A restoration of the SEC to its position from before this current slide simply is not enough. At this moment, we need a dramatic rethinking of our financial regulatory architecture—the biggest since the New Deal. And the SEC will need to undergo changes and evolve to keep pace with a dynamic marketplace.

As we move forward in the process, we must make sure that there is an agency that is independent of the White House, dedicated to mandating transparency with robust law enforcement powers, with the wherewithal and knowledge to oversee and, if necessary, guide risk management, and built around one mission: protecting the interests of investors.

If we do, investors will know that they have someone in their corner, that the markets will be free and fair, and then they will invest with confidence.

Thank you.

Chairman DODD. Thank you very much, Chairman Levitt. I want my colleagues to know as well that I invited both Bill Donaldson and former Chairman Breeden to be with us. Both wanted to be here this morning, but schedules would not permit it. But they are going to come. I am going to ask them back and they would like to come back and be here. And the point you made—I wanted both of them to come—both were Republican nominees. These issues should not necessarily be rooted just in politics, as you pointed out. We have had some very good Chairs of the SEC, and Bill Donaldson and Chairman Breeden I think fall into that category. I am glad you mentioned both their names. As I pointed out, we tried to have them here this morning, but their schedules did not allow them to be here, but I am glad you brought their names up.

Gene Ludwig.

STATEMENT OF EUGENE A. LUDWIG, CHIEF EXECUTIVE OFFICER, PROMONTORY FINANCIAL GROUP, AND FORMER COMPTROLLER OF THE CURRENCY

Mr. LUDWIG. Mr. Chairman and Members of the Committee, I commend you for your leadership in holding these really important hearings on the origins and impact of the crisis developing—evolving in the financial services world. Understanding the root causes of our predicament will allow us to restore our economy and install a regulatory framework that can withstand the challenges of the technology-driven 21st century.

I am honored to testify before your Committee, Mr. Chairman, and to contribute my thoughts and answer any questions you have.

The increasingly painful and heart-stopping developments in the United States and global financial systems are not the result of mere happenstance. We are in the midst of a historic sea change, particularly in the American financial system, indeed in the direction of the American economy itself. The paradigm of the last decade has been the conviction that un- or underregulated financial services sectors would produce more wealth, net-net. If the system got sick, the thinking went, it could be made well through massive injections of liquidity. This paradigm has not merely shifted—it has imploded.

This paradigm implosion is rooted in fundamental imbalances in our economy and financial system, as well as regulatory structures and crisis response mechanisms that are outdated, including importantly:

Consumerism run riot, made worse by domestic fiscal laxity and modern financing techniques;

A deterioration in market conduct, brought on by a short-term profitability horizon, aided and abetted by technology and globalization;

A regulatory hodgepodge involving absent or inadequate regulation of the predominant portion of our financial system and procyclical policies that have not been well conceived;

And, finally, a misguided belief that in financial storms we should let bare-knuckled, free-market capitalism as opposed to compassion and balance rule the day.

By understanding these root causes of our predicament, we can rebuild from the ashes of the current burnout.

For decades we have looked to the consumer as the key driver of our economy. Taken in proportion this is a good thing. However, consumerism has been taken to an extreme, propelled by policies that have resulted in a negative savings rate of historic proportion. Policymakers' excuses that negative savings were not a problem because home prices were rising only caused the consumer to dig a bigger hole for himself. Home and hearth became the consumers' ATM machine as home equity and other consumer loans leveraged the American consumer to the hilt. Such excess would inevitably lead, as it did, to a financial wildfire.

The actual sparks that ignited the fire began to fly in the early months of 2006. It was at this moment when house prices begin to level off and fall while at the same time there was an explosion in the use and availability of novel, low-quality mortgage instruments designed to "help"—and I put "help" in quotes—consumers pump every dollar possible out of their homes.

Our grandparents' generation would have recognized the "help" consumers were getting from financiers and from Government for what it was. Consumers were not being helped. They were being enticed to mortgage not just their homes but their futures and the future of their children on national and personal deficits based on thin promises. The notion that home prices would climb forever and that we could spend our way to financial and national success was accepted unblinkingly. Interest rates held too low for too long, excess liquidity, and structural fiscal and trade deficits based on an imbalanced tax regime benefited the sellers at the expense of those who really could not afford what they were buying.

And this excess, this lack of sound standards, was turbo-charged by the plentiful oxygen of model-driven, structured financial products. Importantly and unfortunately, these highly leveraged products, based on misunderstood and often inaccurate ratings, were distributed throughout the world. Derivatives with even thinner capital bases were in turn piled on top of this mountain of structured products. Acronyms for plain old excessive, underregulated leverage—SIVs, CDOs, CDOs squared, swaps, swaptions—lulled us into a false sense of high-tech financial complacency.

A second major area of failure that brought on the current conflagration has been a marked deterioration over the last several years in market conduct by too many financial services players—mostly, but not only, the un- and underregulated financial intermediaries. So mortgage brokers sold consumers mortgages that were too often inappropriate for their circumstances in exchange for outsized fees. More heavily regulated financial institutions sliced, diced, and bundled the inappropriate mortgages, selling them off to other intermediaries or end purchasers, feeling no compunction because they held no principal risk.

This turn away from traditional relationship finance based on customer care and high integrity standards has been facilitated in part by the increasing financial use of technology and by globalization. Through increasing speed and scale, the face-to-face linkage to the consumer has been attenuated. This has made rules fashioned for a bygone era harder to apply.

Finance is in many ways an information business, and the technological revolution we have been living through has been essentially an information technology revolution. The computer has allowed global connectivity, mathematical/financial modeling, and savings to scale that have created entirely new financial products, and allowed, if not driven, rapid and extraordinary consolidations and concentrations on a global scale unthinkable a decade ago. It has also placed financial firms further away from the end-use consumer.

In a sense, technology, plus globalization, plus finance has created something quite new, often called "financial technology." Its emergence is a bit like the discovery of fire—productive and transforming when used with care, but enormously destructive when mishandled.

Like anything new and dangerous, we should have handled this financial technological fire with great care, with appropriately cautious regulation, with concerns about those—particularly low- and moderate-income Americans—who were touched by it in numerous ways but by no means understood it. But instead of more cautious regulations in this new more dangerous era, we took the regulatory lid off.

Over approximately the last decade, the country has been in the thrall of a deregulatory viewpoint which has left us with too few financial regulatory firefighters too far away from where the fire started and where it has burned the hottest. We have allowed a huge portion of our financial system—perhaps as much as 80 percent—to go un- or underregulated. Indeed, going into this crisis, official Washington not only did not know where all the pockets of mortgage-related risk were; they did not know the magnitude of the risk itself.

At the same time, the regulated portion of the system has been unevenly regulated. Some aspects of bank regulation—for example, in the anti-money-laundering area—have been very heavily regulated with tens of millions of dollars of fines and enforcement actions being piled on enforcement action. Other aspects of finance—for example, credit standards, securitizations, suitability of products for customer usage—have been markedly less strictly regulated.

To add insult to injury, as a result of history and not logic, we have a bank and securities regulatory system that has been unflatteringly referred to as the "alphabet soup" of regulators. This alphabet soup of regulators has exacerbated the problem of overregulation in some areas and created gaping holes in other areas. For example, the "special investment vehicles," the SIVs, which were a great portion of the bank subprime mortgage risk, were off-balance-sheet bank holding company constructs that were essentially completely unregulated.

As if this were not enough, over the past decade we have allowed a number of procyclical and largely untested policies to grow up that are wholly inappropriate and way too rigid. What I mean by procyclical is that regulatory, accounting, and policy standards and practices tend to move in the same direction as the broader economy. The result is a sort of amplifier effect, in which both good times and the bad times are reinforced as their effects are rapidly transmitted through the economy. And one way to think about it is that the failure of our regulatory, accounting, and policy standards and practices to exert a moderating influence at all times is what makes the highs so high and the lows so low; that is to say, this procyclicality that we have built in now to our accounting and other regulatory systems actually exacerbates these swings in the cycle which we are living through right now.

Now, while procyclicality bias sounds rather abstract, it is a real weakness of our financial system with which policymakers must grapple. Some countries already have, as a matter of fact.

Now, how does procyclical bias present itself in clinical terms? We see it in our accounting rules. The concepts around mark-to-market accounting and the relatively recent reliance upon accounting formulas instead of judgments in establishing loan loss reserves clearly added to the financial catastrophe. Mark-to-market accounting by definition cannot work when markets cease to operate correctly. Likewise, we have relied on rigid new accounting rules and models to set loan loss reserves with a mark-to-market methodology that has left the reserves too thin to do their job in difficult times.

More subtle, but of even greater importance, is the accounting governance mechanism that disconnects accounting rulemaking from business and economic reality, as well as from the public policymaking framework. This has resulted in some rules that run contrary to the time-honored principle that accounting should reflect, not drive, economic reality.

Now, every bit as important, perhaps more important even than our off-kilter accounting rules and rulemaking, is that our regulators have allowed short-term pressures to rule our financial institutions. Compensation schemes, too, have rewarded executives for short-term results. All of this has forced our financial institutions, their senior executives, and their boards to "keep dancing" when times were good even though they knew in their hearts that the music would stop with a thud.

Further, Basel II capital standards, though less of an obvious cause, are certainly not a help in these troubled times. Basel II Pillar 1 is itself too new, too procyclical, too complicated and model-driven. There is no evidence that it in any way has helped in the crisis, and there is evidence that it was overly procyclical.

To summarize, gobs of liquidity, consumers on a binge, new highly combustible financial tools, and little effective and overly procyclical regulation has resulted in a financial firestorm. It is as if the modern tools of finance were used to create their magical new fire of finance in the center of our living rooms, filled with highly combustible furniture, and not in a properly regulated fireplace.

Too little, too late. To add insult to injury, the response to the rising heat of the fire was a series of too little, too late steps based on an ideology that the market could take care of itself. Bureaucracies proved less flexible than was necessary. Our responses to the conflagration were typically taken after the next fire broke out, not before.

The capstone of this initial phase of the effort was the decision to allow Lehman Brothers to fail. To my mind this is what started the financial panic, egged on by the failure to support the preferred stockholders in the Fannie and Freddie nationalizations and the decision to treat AIG so differently from Lehman Brothers.

And the panic got out of control because we have allowed short sellers and rumor mongers to roil instead of calm the markets on the one hand and have not had sufficiently flexible circuit breakers to give the markets a bit of a time out on the other.

The TARP, the liquidity facilities being created by the Federal Reserve, and the nationalization of parts of the financial system will ultimately get the economy under control. Ultimately. The key is for the Fed and the Treasury to act vigorously and liberally now with the use of these facilities to remove the much discussed stigma of seeking Government support and move these facilities forward. And I still worry that there is a disconnect between policy and bureaucracy, one that can and should be bridged with great haste at this time.

It is clear that the deregulatory mantra of the last decade is dead. The real question is how far do we go in terms of regulating the financial system. Do we in essence nationalize it, making banking all but a public utility? I fervently hope not. But we have to massively change how we have been regulating and supervising. We have to take better control of the revolutions in technology and globalization. We have to get the fire back in the fireplace.

In order for America to enjoy the benefits of a modern financial system that can allow it to move readily to help rebuild our factories, hospitals, schools, and homes, we need a new regulatory framework, one suited to a technology-driven financial system of the 21st century. Let me quickly go through what I think are the nine key points we need.

One, sound finance must start with fair treatment of the consumer and much higher standards of market conduct. I think this is the No. 1 heart of the problem. We must have a financial system that starts with the consumer and with higher standards of market conduct. We cannot allow any American to be knowingly sold inappropriate financial products as has just taken place too often in respect of subprime and Alt-A mortgage products. For all the good we are doing to bolster the financial system, we will have won the battle and lost the war if we fail to redouble our commitment to keeping homeowners now in their homes.

No. 2, all financial enterprises should be regulated within a unified framework. In other words, financial enterprises engaged in roughly the same activities that provide roughly the same products should be regulated in roughly the same way. The same logic must apply to institutions of roughly the same size. They should be under roughly the same regulatory regime. Just because an institution chooses one charter or one name does not mean it should be able to manipulate the system and find a lower standard of regulation.

Three—and I appreciate your patience—the U.S. must abandon our alphabet soup of regulators and create a more coherent regulatory service. We have a system that is rooted in a proud history, that includes exceptionally fine and dedicated public servants, and that in many ways has served us well in the past. But it is now beyond debate that a banking regulatory framework with its roots in agrarian 18th century America is in urgent need of a radical 21st century change in our global economy. However, the secret to effective regulation is not how we move around the boxes. Mashing the alphabet noodles into one incoherent glob will not make the concoction taste any better. What we need is a much more effective regulatory mechanism. We have to take the whole effort up a notch. We have to put the time and energy into determining both what regulations are effective and what regulations place pure counterproductive and bureaucratic burdens on institutions.

We need to professionalize financial services regulations. We have college degrees for everything from carpentry to desktop publishing to commercial fishing, yet we do not have full courses of studies, degrees, or chairs at major universities in supervision and regulation. America is, in fact, blessed with many talented and dedicated examiners and supervisors, almost despite our system, not because of it.

We need to deleverage the financial system—this is a very important point—deleverage the financial system and country as a whole and restrain excess liquidity buildup. In this regard, we have to encourage savings, eliminate the structural Federal budget deficit, and contain asset price bubbles before they get so large that pricking them brings down the economy.

We must reverse the tendency of the last decade to have procyclical regulatory and accounting policies. Mark-to-market accounting is clearly flawed and must be materially reworked.

Finally, we need to align financial rewards for executives with the well-being of their companies and the stakeholders they serve. Clearly, financial institution governance is off kilter. And to give a king's ransom to traders and other financial executives who have in essence beggared their companies and then walked away from a shipwreck to a comfortable retirement is pernicious. At the same time, executives who take the wheel, stay with the vessel, and steer it through stormy seas deserve to be fairly compensated.

These are but a few elements of what must be a greatly changed financial services system. I have also submitted for the record a lecture I was asked to deliver on this topic recently before the International Conference of Banking Supervisors, which provides a more detailed description of my thoughts on this matter. For America to continue to be a leader in the world and for finance to serve the needs of our people, we cannot wait. We must start now to learn from our mistakes and move forward and rebuild.

Thank you very much.

Chairman DODD. Thank you very much, Mr. Ludwig. I appreciate it.

Mr. Rokakis.

STATEMENT OF HONORABLE JIM ROKAKIS, TREASURER, CUYAHOGA COUNTY, OHIO

Mr. ROKAKIS. Thank you, Mr. Chairman and Members of the committee, for the opportunity to speak to you today. I am the Treasurer of Cuyahoga County, Ohio, the State's largest county, representing Cleveland and 59 cities, villages, and townships.

While the events of the past several months have focused the attention of the entire financial world on the practices of the subprime lending industry, we have suffered the consequences of reckless and irresponsible lending for many years. Since the late 1990's, Ohio and Cuyahoga County have consistently led the Nation in this sad statistic of foreclosure filings.

Consider these numbers. In 1995, 3,300 private mortgage foreclosures were filed in Cuyahoga County and about 16,000 in the State of Ohio. By 2000, the number in Cuyahoga County had more than doubled to over 7,500 private mortgage foreclosures and over 35,000 in Ohio—better than double the number for 5 years earlier. In 2006, there were 13,000 foreclosures—13,600, actually, filed in Cuyahoga County; 15,000 filed in Cuyahoga County in 2007. And, sadly, we are on pace to foreclose on an additional 15,000 properties in Cuyahoga County in 2008.

I am accompanied here today by Professor Howard Katz, a professor of law from Elon University, who was our Director of Strategic Planning in Cuyahoga County back in 2000. Professor Katz and I approached the Federal Reserve Bank of Cleveland in the fall of 2000 to ask for their help in controlling the reckless lending practices that were doing real harm to Cleveland neighborhoods, harm I describe in detail in an article I wrote for the Post entitled "Shadow of Debt." We knew the Fed had the authority to act under HOEPA, the Home Ownership Equity Protection Act, and under the truth-in-lending laws. Our hope was that the Fed would step up once they knew the extent of the problem. That was our hope. The Fed cosponsored a 1-day conference in March of 2001 entitled

"Predatory Lending in Ohio" where we discussed potential solutions, Federal, State, and local. Our keynote speaker, Mr. Chairman, was Ed Gramlich, the late Fed Governor who passed away in 2007. We had contacts from the Fed that said that late Governor Gramlich understood the nature of the problem. As we all know now, he had warned Fed Chairman Greenspan about the need to regulate these practices. Nothing of substance came from this conference. In frustration, local ordinances were passed later that year in Cleveland, Dayton, and Toledo to try to slow down the practices of the mortgage bankers and brokers. Within 90 days of these ordinances passing, the Ohio Legislature passed a law pre-empting the right of Ohio cities to regulate in this area.

In early 2005, I approached the U.S. Attorney of the Northeast District of Ohio, U.S. Attorney Greg White, and requested a meeting of Federal and local officials to deal with these practices from the enforcement side. We knew we were the victims of fraud on an industrial scale. This meeting included U.S. Attorney White, other Assistant U.S. Attorneys, FBI agents, and postal inspectors where we begged that Federal authorities make this enforcement issue a high priority.

I still remember one Assistant U.S. Attorney making the point that they had received not a single complaint from any of the mortgage banks involved in these loans. He asked me, and I remember, "If they aren't complaining, who are the victims?" Well, Mr. Chairman, the victim was the homeowner who lived on a stable street and woke up 1 day and found that there was a vacant house next to him, and a month later one across the street, and a year later three more on that street. That entire neighborhood was victimized by this, and as we have come to learn now, Mr. Chairman, the victim is the entire world.

For the record, a very limited number of prosecutions came as a result of these meetings. The only significant prosecutions in our community have been by the county prosecutor's office. We tried, Mr. Chairman and Members of the Committee, we did try. We were ignored. There were others who tried to warn the Federal Government about this problem, the Fed, but we were no match for Wall Street.

Mr. Chairman, I would like to take my remaining time to discuss the attempts, as you have and others here, to pin this entire crisis on the Community Reinvestment Act of 1977. You all know what the CRA is, what it does. I do not need to get into the details. But if you really want to understand how silly this allegation is, all you need to do is look at the lending data for the city of Cleveland.

The peak year for home purchase mortgage origination in Cleveland was 2005. A local nonprofit research organization, the Housing Research and Advocacy Center, has analyzed the HMDA data for that year. They found that of the top ten mortgage originators in the city that year, only four were affiliated in any way with local depository banks, and those four accounted for less than 15 percent of the total mortgages originated.

Of the 7,100 Cleveland mortgages reported in HMDA data that year, 1,258—almost 18 percent—were originated by the now defunct subprime lender Argent Mortgage. Argent was never covered by the CRA.

The second largest Cleveland lender that year was New Century Mortgage, also now defunct, with about 5 percent of the total.

The third largest lender, also accounting for about 5 percent, was Third Federal Savings, which I have to say, Mr. Chairman, there are some heroes in this crisis. Third Federal Savings and Loan has been one of the few really good guys in this industry, at least in our community. They have done an outstanding job. They did not make these kinds of loans.

Numbers 4, 5, and 6 and others on that list, again, were companies like Aegis, Long Beach Mortgage, and others, which were not covered by CRA.

Finally, way down that list, we get to banks like Charter One, National City, and Fifth Third, but they each only had about 3 percent of the market, adding up to about 648 loans. Did they make these loans to help their parent institutions' CRA ratings look better? Possibly. Did these 648 loans play a major role in the city's default and foreclosure crisis? Hardly.

I realize I am out of time, but I would like to just point to one bit of statistic. As dangerous as mortgages, Mr. Chairman and Members of the Committee, were the home refis. If you look at the home refi data, you will find that they, first of all, equaled the number of home purchase mortgages. Refis have been very destructive in our community, have resulted in many foreclosures. And if you look at the refi data, Mr. Chairman, only 7 percent of those loans were made by CRA-affiliated institutions.

The foreclosure crisis in Cleveland for the last 6 years has not been driven by CRA-covered depository banks, even though some of them—notably National City—were minor players. The problem has been driven by Argent, New Century, Aegis, Countrywide, Long Beach, and others, dozens of other subprime and high-cost loan peddlers with no local depository services and no CRA obligations in our community.

Thanks for the chance to be on this distinguished panel.

Chairman DODD. Thank you very, very much. I appreciate your testimony.

Marc.

STATEMENT OF HONORABLE MARC H. MORIAL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL URBAN LEAGUE

Mr. MORIAL. Thank you very much. It is almost afternoon, but good morning.

Let me, first of all, say that I am proud to be here on behalf of the National Urban League, its 100 affiliates who exist in all of the States and cities represented by Members of the Committee. I am also here representing the Black Leadership Forum, an umbrella organization of some 30-plus African American-focused organizations from coast to coast. I serve this year as its Chair.

I come today to set the record straight about what I call the "financial weapon of mass deception," the ugly, insidious, and concerted effort to blame minority borrowers for the Nation's current economic straits. This financial weapon of mass deception, as false and outrageous as it is, has taken hold, thanks to constant and organized repetition and dissemination through the media, political circles, newspapers, and the Internet.

It is not a harmless lie. It is a stretching of the truth for fleeting political advantage. It is an enormously damaging and far-reaching smear designed to shift the blame for this crisis from Wall Street and Washington, where it belongs, onto middle-class families on Main Streets throughout this Nation.

For years, the National Urban League and others have raised the flag and urged Congress and the administration to address the predatory lending practices that were plaguing our communities. For example, in March of 2007, I issued the Homebuyers Bill of Rights in which I called upon the Government to clamp down on predatory lending and other practices that were undermining the minority homebuyer and homebuyers of all races. Unfortunately, not only did our call go unheeded, but also we spent time right here in this Congress fighting back efforts to preempt the ability of States to regulate predatory practices. Now disaster has struck.

Many of those who caused it are trying now to blame communities of color and urban communities and those measures that helped clear the way for qualified people to purchase homes—most notably the Community Reinvestment Act. In fact, it was the failure of regulatory policy and oversight that led to this debacle that has been completely expressed by every one of the three witnesses that have gone before me.

But I want for the record to share with you some plain and simple facts, stubborn facts, Senator Dodd. It was Wall Street investors—not Fannie Mae and Freddie Mac—who were the major purchasers/investors of subprime loans between 2004 and 2007, and we have a chart that demonstrates this very clearly that we will make a part of the record.

No. 2, while minorities and low-income borrowers received a disproportionate share of subprime loans, the vast majority of subprime loans—the vast majority—went to white middle- and upper-income borrowers. The true racial dimensions of the housing crisis have been reported in places like the New York Times, and that is expressed by another chart.

Third, African Americans and Latinos were given subprime loans disproportionately compared to whites, according to ComplianceTech, a leading expert in lending to financial services companies, researcher to financial services companies. Also, African American borrowers were more than twice as likely to be scared into a subprime loan as white borrowers.

In each year from 2004 to 2007, non-Hispanic whites had more subprime rate loans than all minorities combined.

In 2007, 37 percent of African American borrowers were given subprime loans, versus 14.21 percent of whites, according to ComplianceTech. More than 53 percent of African American borrowers were given subprime loans compared versus 14 percent of whites, according to ComplianceTech.

The vast majority of subprime rate loans were originated in largely white census tracts.

The volume of subprime rate loans made to non-Hispanic whites dwarfs the volume of subprime rate loans made to minorities.

In each year, the white proportion of subprime rate loans was lower than all minorities, except Asians.

I want to point out that while the majority of subprime loans did go to white Americans, African Americans and Hispanics were disproportionately steered into subprime loans. At the end of the day, this is a problem that affects Americans of all races, and I urge this Committee to strongly and publicly not only affirm that but to challenge the false assumptions being peddled by the agents of mass deception.

Upper-income borrowers—upper-income borrowers—had the highest share of subprime rate loans during each year except 2004, where middle-income borrowers had the highest share. The misconception is that lending to low- and moderate-income Latinos and African Americans caused this problem. The stubborn facts, not hidden but in the Mortgage Disclosure Act, clearly affirm this point.

It is clear that a large number of people who ended up with subprime loans could have qualified for a prime loan, and the incentive system set up for brokers and originators which incentivized steering people into higher-rate loans was one of the causes of this.

Non-CRA, as the Treasurer mentioned, financial services companies—non-CRA financial services companies were the major originators of subprime loans between 2004 and 2007.

These facts are unequivocal. They are clear. And they are indisputable. There have been commentators, some who hold a great deal of respect, who write and broadcast, some members of the other side of this Congress, who for some reason have peddled this story of mass deception as though they were reading off a set of political talking points.

As we have seen in numerous Internet blogs, highly trafficked sites, this baseless blame game has turned into vicious attacks on the Internet directed at African Americans, Latinos, Jews, gays, and lesbians.

In the last few weeks, I have undertaken an aggressive campaign directed at the Nation's financial leaders to dispel this myth. I have written to Treasury Secretary Paulson and Federal Reserve Chairman Bernanke and asked that they publicly refute claims by these pundits and politicians that most of the defaulted subprime loans at the root cause of the crisis were made to African Americans, Hispanics, and other so-called "unproductive borrowers."

On the basis of hearsay, on the basis of rumors, on the basis of statements made by respected commentators, the seeds of division around this financial crisis are being sown in this Nation. History tells us too many times that the consequences of singling out only certain segments of the population as culprits for the Nation's woes for us not to do all within our power to stop these attacks, to end this smear campaign in its tracks, requires—and I would ask and urge that this Committee join us in the strongest possible terms available to stand up to this lie, to stand up to these agents of mass deception, to stop the waste of discussion and time being spent on blaming victims and force, as this Committee seeks to do, a healthy debate on what must be done to curb too much Wall Street greed and too little Washington oversight. This hearing is an important start toward that.

So I urge you to stay focused and take strong and positive steps to strengthen our communities and this Nation's financial foundation through regulatory reform.

Finally, with respect to regulation, I want to encourage the Congress not to leave it to the rulemaking authority of the Federal Reserve to regulate anti-predatory lending. I urge this Congress, I urge this Committee to take the lead, as you suggested, Senator Dodd, to codify the boundaries going forward for the type of loan products that financial services companies are going to be able to offer to the American people.

No. 2, an area of failed oversight and regulation not mentioned thus far has been the failure to enforce fair lending laws. Both the Department of Justice and the Department of Housing and Urban Development ought to be called to account, ought to be called to be transparent, on where they were as this crisis has fomented, because they, too, have a very important responsibility in enforcing laws on the books.

No. 3, the Community Reinvestment Act is a very important vehicle that has yielded great benefits for this Nation. The idea that it has been assigned responsibility and blame for this crisis is so far-fetched, so imaginary as to almost not merit a response. But we know that there are those who for years have held it close on their legislative agenda to try to water down, to try to eliminate, to try to undercut the Community Reinvestment Act. I would suggest that at a time when the taxpayers of this Nation have been asked to take an unprecedented move—that is, to authorize the Treasury to invest taxpayer dollars in the preferred stock of financial services corporations—then the direction that the Congress should take in exchange and in return is not a weakening of the Community Reinvestment Act, but a strengthening of the Community Reinvestment Act and its enforcement mechanisms.

So, Senator Dodd, I thank you for your leadership. I urge the Committee to take a very strong stand, and I thank you for your time today.

Chairman DODD. Thank you very, very much, Mayor. And let me just on that point, before turning to Mr. Stein, I am somewhat reluctant to quote the Wall Street Journal on this point, but the Wall Street Journal noted that between 60 and 65 percent of subprime borrowers actually would have qualified for conventional mortgages; 60 to 65 percent of those borrowers would have qualified for less costly mortgages.

As you may recall, for those who were here, we had the first hearings and had the representatives from the Brokers Association. We put up the Web page, and the first instruction to brokers from their association was, "Convince the borrower that you are their financial adviser." The most deceptive of practices. They were anything but the financial adviser to the borrower. And as a result, literally thousands and thousands of people ended up with mortgages vastly more expensive than ones they qualified for. That is criminal, in my view.

And to make your point, let me just quote on the last point—or the first point you made in your testimony, just to make your point, this is a commentator that wrote an article called "They Gave Your

Mortgage to a Less Qualified Minority." And let me quote, if there is any doubt about what you just said. Listen to this quote:

"Instead of looking at outdated criteria, such as the mortgage applicant's credit history and ability to make a downpayment, banks were encouraged to consider non-traditional measures of credit-worthiness, such as having a good jump shot or having a missing child named Caylee." The article goes on to say that, and I quote, "Ultimately, the housing bubble burst and, as predicted, food stamp-backed mortgages collapsed." The article goes on and refers to this kind of mortgage crisis "as an affirmative action time bomb that has gone off."

If there is any doubt about what Mayor Morial just said, that is the kind of articles that are appearing all across the country, and the data is, of course, entirely the opposite. The facts are entirely the opposite. And so I appreciate immensely you testifying this morning about this theory that is being promulgated.

I remember Paul Sarbanes, who chaired this Committee—he is a great friend of mine, a great Chairman of this Committee. Chuck Schumer and I—he was a House member in those days, in 1999, we sat up all night on that 1999 law to fight those on this Committee and elsewhere who did everything in their power to get rid of the Community Reinvestment Act, and we prevailed. I think, Bob, you may have been in the House that year, maybe on the Banking Committee. But I will never forget staying up until 5 and 6 o'clock in the morning to fight to keep the CRA. And so I appreciate very much your testimony.

Mr. MORIAL. Thank you, Mr. Chairman.

Chairman DODD. Mr. Stein, welcome.

STATEMENT OF ERIC STEIN, SENIOR VICE PRESIDENT, CENTER FOR RESPONSIBLE LENDING

Mr. STEIN. Good afternoon. Chairman Dodd and Members of the Committee, thank you for the opportunity to testify.

In the middle part of this decade, Wall Street demand led to literally trillions of dollars of subprime and Alt-A loans to be originated. What was interesting about it was that Wall Street paid more the more dangerous the loan was. For example, in 2004, Countrywide, if they gave a borrower a fixed-rate conventional mortgage, they received 1 percent. If they put that exact same borrower in a subprime loan, they received 3.5 percent.

It is not a surprise that they paid their originators more if they put that borrower in the more expensive loan, the one that statistically has been shown more likely to cause a foreclosure.

Wall Street then bundled these mortgages into mortgage-backed securities, and credit rating agencies, paid by the issuers only when they are issued, found many too many of them to be AAA quality. And then they were sold around the world.

In 2006, the top five investment banks earned $1.7 billion in revenues structuring and packaging these subprime mortgage-backed securities. These are the loans that helped cause the housing bubble, and what they have in common, the subprime and the Alt-A loans, are that they start at what seems like an affordable level, but built into the structure of the loan is unsustainability. They start cheaper, but then they get more expensive. There is no free lunch in a mortgage. And that is what they have in common, and that helped build the housing bubble because people were put in a larger loan than they could actually afford, and on the flip side, once the bubble burst, it caused the massive foreclosures that we have now because when the housing bubble was going up, that unsustainability was masked. Once people could not afford the mortgage, they could refinance or they could sell. When the bubble comes back down, they no longer have those options, and that is why we have the foreclosure crisis that we have today. This leaves the question: This is what Wall Street was doing. Where were the regulators? I will not repeat what has been said. I will just identify a couple, and my testimony goes into more regulatory failings.

The first is the Federal Reserve. Back in 2000, my boss testified, and Chairman Leach, I remember him saying that the Federal Reserve is AWOL because they received the authority to prevent abusive lending in 1994 and had not used it.

The second one that I would like to mention is the Office of Thrift Supervision. They allowed Washington Mutual and IndyMac to push abusive mortgages until they failed and did not even put them on the watchlist until right before they failed, so the FDIC could not clean them up sooner.

It is clear now that a lack of common-sense rules, like how about only making a loan if the borrower can afford it, actually impeded the flow of credit beyond anybody's wildest dreams. Many of us who were trying to get the regulators to crack down on predatory lending abuses were fighting a defensive action in Congress, saying don't preempt the State laws that are there, since the proposed bills would have made the situation worse. And the regulators would always say, "We cannot stop the free flow of credit," and we can see the results today.

Since the problem is rooted in excessive foreclosures, the solutions must start there. I would like to identify five very briefly.

The first is that Congress should lift the ban on judicial loan modifications, which would allow hundreds of thousands of families to have their loans restructured and stay in their homes at no cost to taxpayers. We are spending $700 billion when we can do something that is free.

In Chapter 13 bankruptcy, the only secure debt that cannot be modified is the home on the principal residence, whereas loans on a yacht or investment property can be modified now. I would like to illustrate that point for a second.

If you consider Candace Weaver, who is a school teacher from Wilmington, North Carolina, in 2005 her husband had a heart attack, and she refinanced her mortgage with a lender called BMC. She received what seemed like a reasonable rate, a little bit high, 8.9 percent. Two years later, it turns out—she was not told this—it was an exploding 2–28 subprime mortgage. The rate goes up to 11.9 percent, which she just could not afford. She was diagnosed with kidney cancer and had surgery scheduled. She called the servicer and said, "I cannot make my July payment. This payment is too high. I can barely make it. But I cannot make the July payment because of surgery." The servicer said, "I am sorry. I cannot even talk to you until you are delinquent."

She had the surgery, became delinquent because she could not keep it up, called again, and they said, "We cannot talk to you until you are in foreclosure."

Then she can't keep up, she actually goes into foreclosure, calls again, and they say, "OK, we will give you a repayment plan. Make your current payments of 11.9 percent, and on top of that catch up the past payments that you did not make," which she could not do. The bankruptcy judge cannot help her even though she could afford a market rate mortgage.

Consider, on the other hand, Lehman Brothers. They were among the biggest purchasers and securitizers of subprime loans, earning hundreds of millions of dollars. They were a huge investor in these mortgages at 30:1 leverage, which caused their failure, and hurt everybody. Finally, they owned a mortgage lender named BMC, the exact same lender that is potentially costing Ms. Weaver her home—hopefully not because she has representation now.

The Wall Street Journal investigated BMC Mortgage and found widespread falsification of tax forms, cutting and pasting documents, forging signatures, ignoring underwriter warnings. Lehman Brothers last month, as everybody knows, went to bankruptcy court. They can have their debts restructured, but Ms. Weaver cannot.

The second thing I would focus on is for Treasury under the TARP program to maximize loan modifications, as some of the Senators have mentioned. Whenever Treasury buys equity in a bank, buys securities from a bank, buys a whole loan or controls a whole loan, they should do the streamlined modification program that Sheila Bair is doing at FDIC. What she does is target an affordable payment, first by reducing the interest rate, then by extending the term, then by reducing principal if you need to. And they should focus on a 34-percent debt-to-income ratio, which is the target in the Attorney General settlement with Bank of America over Countrywide.

The other thing that they should do, which I think you had something to do with, Senator Dodd, is to guarantee modified mortgages, which would be cost-effective, but you need to make sure that the mortgage is modified well. But that could be a powerful tool.

The third thing I would suggest is go ahead and merge OTS into OCC. They have not proven up to the challenge.

Fourth, the Federal Reserve should extend their HOEPA rules to cover yield-spread premiums, broker upselling, and, second, extend the subprime protections to nontraditional mortgages. Those are problematic now, too.

And, finally, Congress should pass the Homeownership Preservation and Protection Act—two things to mention there—that Senator Dodd sponsored and many Members of the Committee co-sponsored. This would stop abuses. First, no preemption. If there is preemption, there should not be a bill because the States are doing all they can. And, second, if anything is clear by now, it is that Wall Street will pay best money for mortgages and loans that help their short-term profits and that originators will supply those if they are paid well for it. But that is not necessarily the same thing as a long-term sustainable mortgage for the homebuyer. Purchasers need a continuing financial incentive to ensure good lending through the imposition of strong assignee liability.

Thank you very much.

Chairman DODD. Well, thank you very, very much, and just on your last point, my intention is if we have a lame-duck session, which we are apt to have after the elections, and if there is a package that may move forward, a stimulus package, my intention is to take the predatory lending bill which we craft in this Committee, along with the credit card legislation, along with a moratorium on foreclosures—and there is one other item—the bankruptcy provisions that would deal with that single home that people have, in a package then and ask our colleagues to support those measures. We have done a lot here for the financial sector of our economy. We have not done anything yet, in my view, very significantly, for the consumer side. And so in November my hope is we can package that together, make it part of that stimulus package that may be forthcoming, and give our colleagues a chance to do something before the Christmas holidays. It might provide some relief for people. Ten thousand a day. Every day that goes by—every day that goes by, imagine. And as you point out so accurately, when you get into the court proceeding, as people told me in my own State yesterday, once you are in that court proceeding, too often the lender says, "I would like to help you, but I am instructed I cannot do anything now. We have to complete the legal process." And I am getting a thousand a week of those in Connecticut, and I know other States are going through many more as well.

Well, let me raise some questions here, and I will put up a brief clock because you have been very patient, all of you.

We have talked a lot about CRA, and I think that is important. But also, the second theory—and, again, I thank my colleagues here and I thank Barney Frank and his colleagues in the House—that after many years of debating and discussing what to do about the GSEs, we actually did it this year. And as pointed out, I think by Sherrod Brown, or others, in 2005—Mike Oxley deserves a lot of credit. He and Barney Frank put together a bill, and it had 331 supporters in the House, 90 opponents. Then came in Senator Sarbanes, offered that proposal, slightly modified, to appeal to people over here, and it went down on a party-line vote. That was the bipartisan bill that would have done something in 2005. But what this Committee finally did this year is make those modifications and corrections.

But there is this story going around, this was all about a Fannie and Freddie problem, and I wonder, Mr. Stein, if you might address that issue. To what extent is there accuracy in that? Is there a legitimacy in that argument? Or is it overstated, in your view? And I will ask anyone else on the Committee who wants to comment on this your own thoughts. What is the true answer to that question?

Mr. STEIN. I think it is substantially overstated. I think Fannie and Freddie followed the market. They did not lead the market. They did purchase the senior tranches of AAA subprime securities, and that was a bad idea because they are supporting a bad market, and they end up not to be very good loans. But these were the marketable AAA tranches that others would have purchased, and as someone mentioned earlier, those percentages declined as the subprime market went way up.

The problem is that people conflate the subprime securities with what caused Fannie and Freddie to have financial problems, but actually, those were the Alt-A mortgages talked about earlier that did not document income. Those are the higher-income borrowers. Those actually diluted their affordable housing goals. Ten percent of their mortgages are Alt-A mortgages; 50 percent of both Fannie's and Freddie's losses are Alt-A losses.

The critique that if Fannie and Freddie had not purchased those securities that subprime abuses wouldn't have happened is ridiculous because they were originated by Wall Street, Wall Street packaged and promoted the products, the originators were making those loans, and often the people saying Fannie and Freddie are to blame do not want any sort of regulation on the people that actually made the mortgages and made them happen. So I think it is a pretty weak argument.

Chairman DODD. Any other comments?

Mr. MORIAL. I wanted to add one other point. When Fannie and Freddie sort of followed the market, they relaxed a critical underwriting rule that they had followed for years, and that was the rule that they would purchase mortgages where the homebuyer had been through pre-purchase counseling as a mandatory requirement. And my understanding is that that rule got relaxed to some extent because they had pressure from the sellers who said, "I can sell to somebody else now. I do not need to sell to you, and all of your sort of requirements are too burdensome for the type of business that we want to do."

So it is an affirmation of what this Committee has strongly supported twice in the last year, and that is, an increase in investment in homeownership counseling. I think any view toward a new system, if you will, for housing finance in this country ought to place heavy emphasis on pre-purchase homeownership counseling. I believe the data will show that the default rates and the foreclosure rates are less where purchasers have had the benefit of homebuyer education prior to purchase.

Chairman DODD. I agree.

Gene or Arthur, do you have any comment on this issue that has been raised, the Fannie and Freddie argument?

Mr. LUDWIG. We really need to rethink how Fannie and Freddie——

Chairman DODD. Do you want to turn your microphone on?

Mr. LUDWIG. We have to really rethink, Mr. Chairman, how Fannie and Freddie fit in our financial system.

Chairman DODD. I agree with that totally.

Mr. LUDWIG. They have been really beat on in the last 8 years as orphans that do not need to exist, and that may or may not be true, but we have not had an architecture of how they really fit.

My own belief is that they are very important props and should have been key factors in solving the current crisis. But they frankly were so constrained earlier in the decade that they were not in a position to be able to help.

Chairman DODD. Arthur, any thoughts on that subject matter?

Mr. LEVITT. I think with adequate supervision and adequate regulation, they are an important part of our market.

Chairman DODD. Let me, if I can, I wanted to get Gene Ludwig, if I could, to pick up on this. And, again, we heard the comments on CRA, and, of course, you had dealt directly with this issue when you served as Comptroller of the Currency, and you have some insight into the experience with CRA.

At the time you were Comptroller, OCC worked with other banking agencies to overhaul CRA regulations, and you have had experience supervising CRA lending and investment by banks. I wonder if you could tell us about whether CRA helped to fuel the current economic crisis in your view. And on the topic of CRA, I would like to—well, I read that comment earlier. I wonder if you could just pick up on those thoughts as well about the pernicious argument being posed by those who suggest the CRA was a part of this or a major cause of this problem.

Mr. LUDWIG. Mr. Chairman, I commend you for focusing on this very important matter, and I share the views expressed by the other members of the panel today. CRA is about our better instincts, it is about a better world. I have done a study for the Boston Federal Reserve and the San Francisco Federal Reserve which will be published in January at their request on this very topic. And the notion that CRA has caused this problem is a pernicious thought. It goes to your comment that this is just not—these are not truthful statements. And my panelists have covered it very accurately. This just is not the case. CRA has helped to create a better and sounder world for finance, not the opposite.

Chairman DODD. Well, thank you.

Mr. LEVITT. I think a market that has to be believed in by public investors has to be fair and open. And I must say the testimony we heard before was absolutely inspiring because it has not been fair and open. It has been loaded with innuendo and statements that, as Americans, we should all find appalling.

Chairman DODD. Arthur, let me ask you, if I can, about something you have raised already in your opening statement, but I want to pursue it a little further with you, and it will be my last question before I turn to my colleagues.

SEC Chairman Cox testified before this Committee on September 23rd of this year about, and I quote, "a regulatory hole that must be immediately addressed, the $58 trillion national market in credit default swaps, which," he noted, "is regulated by no one. Neither the SEC nor the regulator has authority over the CDS market even to require minimal disclosure to the market." And he asked Congress for the authority to regulate.

What role did the absence of such authority, in your view, have in the current crisis? And which specific authorizations would you recommend be given to the SEC to regulate over-the-counter swaps and other credit derivatives?

Mr. LEVITT. This is an issue that came up in 1998 when the President's Working Group was confronted with a recommendation by the Chairman of the CFTC to regulate swaps. Chairman Greenspan felt that this would cast trillions of dollars of outstanding contracts into a situation of what he called "legal uncertainty." All 20 or so members of the working committee, with the exception of Brooksley Born, supported Chairman Greenspan, as did I.

We also called for a clearinghouse to be established to give greater transparency. Unfortunately, we did not mandate that clearing facility. As I reflect back upon that period, I wish that I had probed further. I wish that I had asked for swaps and derivatives to be given the transparency which has led to many of the problems that we face today.

What do we do now? I think no longer can we assume that these are instruments used by sophisticated investors, and the fact that they are unregulated, listed on no exchange, and have permeated our markets at every level no longer allows that condition to continue.

I believe that an SEC, CFTC, a merged entity, should have oversight of the whole derivatives market, should have oversight in a way that is reasonable and practical and cost-effective. If I could wave a magic wand and do away with derivatives, I would not do it. They have been a valuable, important, essential, liquefying factor and risk-protecting factor in our markets. However, as I believe Gene said before, improperly used, their impact can be devastating.

We are entering what I believe will be a decade of transparency. In that connection, I think derivatives must be more transparent. I think the agencies to do that are the CFTC and SEC. I do not believe that that should be—that our regulation should be Fed-centric, as outlined in the Secretary's blueprint. I think that blueprint marginalizes many other agencies, including the SEC. And I think in terms of investor protection that would be a tragic mistake.

Chairman DODD. One other quick question on this. Can you make the correlation between what you have just said and the crisis? People talk about these derivatives, and I do not know if it has been clearly explained about why those instruments, as they have been working, actually have affected the very crisis we are in, connecting the dots between the two. I do not think that has been well done.

Could you do that for us?

Mr. LEVITT. Well, what derivatives essentially are, they represent leverage on leverage, having narrowed the margin of error. If you traded stocks or bonds or mortgages in the past, and a mistake was made, you had time to correct that mistake. With derivatives it is a millisecond. And the problem is that we are talking about trillions of dollars without a clearing facility to be able to tell us whether Customer A can complete a transaction with Customer B. And I dare say that a lot of these contracts without a clearinghouse simply do not have counterparties to account for them.

We will find out more about that as the Lehman Brothers bankruptcy winds its way through the courts. The key issue here is a clearinghouse. The ultimate failure that we talk about in terms of systemic failure in the United States in my judgment is a clearance failure. We have clearinghouses with respect to stocks and bonds and options. It is unthinkable that we have yet to have a clearing facility for these derivatives.

Chairman DODD. And a lot of these instruments, of course, we are talking about some of the subprime mortgages.

Mr. LEVITT. Yes. They were packaged——

Chairman DODD. That is my point. So that is the point. These were these things moving through with the subprime. That is the piece that I think is missing in this.

Yes, Gene, do you want to comment?

Mr. LUDWIG. Yes, Mr. Chairman, I agree with what Arthur said. They are one part of what has become a faceless, high-technology liquification. It is as if you sort of have huge amounts of liquid pouring into homeowners' living rooms, opportunities to borrow, new opportunities to mortgage themselves. It is one piece of a chain that is faceless, where people who are part of it are not connected in any way to the end-use customer. And getting this right has to start with making sure that the end-use customer, the product is safe for that person's use, and making sure that up the chain people have a sense of responsibility for the risks they are taking on, which has not been part of it. The derivatives tend to explode this because they tend to be highly leveraged, but it is one part of a bigger puzzle, sir.

Chairman DODD. I thank you both very much.

Mr. MORIAL. Senator Dodd, I am going to have to excuse myself. I want to thank you and——

Chairman DODD. Let me turn to my colleagues here and see if they have a question for you before you walk out of the room.

Senator BROWN. I do not, Mr. Chairman.

Chairman DODD. Thank you, Mayor, very much.

Senator BROWN. Thank you, Mayor.

Mr. MORIAL. Thank you very much. Thank you.

Chairman DODD. Senator Brown.

Senator BROWN. Thank you, and thank you, Mayor Morial, for your public service and——

Chairman DODD. Thank you, Mayor, very much.

Senator BROWN. Mr. Rokakis, I will start with you. I have several questions. Secretary Paulson testified before our Committee on the need for intervention 3 weeks ago to shore up financial markets. As you know, while he originally sought authority to purchase troubled assets, he now appears to be heading in a direction that some of us preferred, which is buying a stake in troubled companies.

All along, one of the things that I know troubled you and troubled a lot of us on this Committee is the ineffectiveness of either of these approaches in addressing the underlying problems in the housing market.

One suggestion that has recently been made is to buy up all the troubled mortgages at face value. While I am sympathetic to the goal of helping homeowners, this proposal strikes me as pretty generous to the people who got us in this mess in the first place.

I understand that in the home you lived in growing up, the vast difference between the mortgage value versus the actual value that you have talked about publicly and privately. Give me your thoughts on that.

Mr. ROKAKIS. Thank you, Senator Brown. If you buy these at face value, you are going to guarantee billions and billions of dollars of losses for the U.S. Government. I have testified before Senator Schumer's Committee in particular about Argent Mortgage. Argent was a wholly owned subsidiary of Ameriquest, now out of business. Argent Mortgage did not make a single loan in Cuyahoga County in 2002. By 2003, they led in two categories: mortgages issued and foreclosures. They led in that category in 2004, 2005, and 2006. The negative equity of the Argent loans in Cuyahoga County is probably somewhere in the nature of $300 to $350 million. I used this when I came to the earlier Committee. Maybe we showed the color-coded graph. Virtually all of these loans were made for at least 150 to 175 to 200 percent of the auditor's value. If you buy those—first of all, that was then, but this is now. We are talking about many thousands of foreclosures later. Those properties may have been worth that much when the mortgage was issued, that much less, but they are worth even less now. Many of them are empty. They have been gutted. They are in communities where there are a lot of additional properties that are empty as a result of this foreclosure crisis.

If you buy them at face value, Mr. Chairman, Members of the Committee, you are guaranteeing yourself, I believe, tens of billions of dollars of losses. I cannot speak for other markets. I can only speak for what I have seen in Ohio and particularly Cleveland.

Senator BROWN. Thank you, Mr. Rokakis.

Mr. Levitt, it seems like among all the other things we have outsourced is the enforcement of investor and consumer protections over the past few years. Whether it is the mayor of Cleveland forced to sue lenders or the New York Attorney General stepping in on repeated occasions, it does not seem like these days the SEC has particularly done its job. Some at the SEC might argue it lacks authority.

My question is: Is that true, it lacks authority? And if so, didn't the leadership of the SEC have an obligation a long time ago to ask for greater authority?

Mr. LEVITT. I do not believe the SEC does lack authority. I think the SEC is starved for resources. They have not been given—as a matter of fact, they rejected additional funds that were offered to them by appropriating committees.

Senator BROWN. When was that, Mr. Chairman?

Mr. LEVITT. I beg your pardon?

Senator BROWN. When was that that they rejected——

Mr. LEVITT. Sometime over the course of the past 2 years, 3 years. I will get back to you with the specific time of that. But so much of what the SEC does, as I said in my statement, is the sending of signals, the speeches given, not the rules that are passed. And those signals simply have not been sent.

Shareholder access to the proxy, a terribly important issue. It has been bubbling around for 10 years now, and the Commission failed to act. A non-binding shareholder vote on executive pay, again, bubbling around for some years. The Commission did not act.

Over and over and over again, the message was sent that this Commission is not an investor-friendly Commission. I do not think this is a question of authority except with respect to such issues as derivatives. There clearly we are in an unregulated area, and a lot of us were responsible for not calling attention to this early on. There is more I could have done while I was there, and the condition grew worse and worse and worse.

I do not believe this is a question of giving the SEC authority that they lack. I think it is a question of the SEC properly utilizing that authority, reinvigorating their Enforcement Division, which has been demoralized by a variety of factors. Giving them more cops on the beat, allowing them to send a message which only they can send that they truly are the investor's protector.

Senator BROWN. Thank you, Mr. Levitt. One last question, Mr. Chairman, if I could.

The 40,000 angry e-mails and letters and calls I received told me—and they have said it repeatedly—that this is not a natural disaster, this is a man-made one. I would guess, I would say likely, that most of the 40,000 believe that some of this behavior was illegal. There seems to be certainly no self-imposed accountability.

Mr. Ludwig, while we do not really know the facts yet, do you think the architects of this disaster might be held accountable by the law?

Mr. LUDWIG. There clearly are victims here, and there clearly are violations of the law without question. That is a big part of it. It is not the whole part of it. We are at a time in history, Senator, where the entire system needs to be radically remade in this country. There are parts of it that simply will not function if not markedly changed. But it starts with the consumer. There clearly were elements here where people were cheated badly, and they were victims, and there needs to be accountability.

Mr. LEVITT. I agree with that totally. I think there are so many areas in corporate America in recent years of bad behavior that has disillusioned the public. The pre-dated stock options, the misdeeds in San Diego of the custodians of the pension fund—these are all areas that could have been front-page headlines with regulators doing the right thing.

Regulators cannot capture every bit of wrongdoing, but they can bring and promote signal cases to deter practices of that kind. And we need much more of that than we have had.

Senator BROWN. Mr. Stein, any thoughts you have on potential criminal activity, without, again, knowing all the facts? And I do not ask you to be more specific than you can——

Mr. STEIN. We have a little litigation arm that represents borrowers such as Ms. Weaver that I mentioned. The converse of victims were fooled is people doing the fooling, and I do not know anything worse than stealing somebody's home and ruining somebody's neighborhood, ruining an economy. So I think there should be accountability. I think there should be.

Senator BROWN. Thank you.

Thanks, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you all for your testimony. It has been very elucidating and I appreciate it.

Chairman Levitt, let me ask you, you know, I appreciate your responses to the Chairman on the whole question of credit derivatives is a market that grew to over $62 trillion in value and only $6 trillion in loans, so it gives you an example of the need for the transparency there. But isn't there even a greater need for transparency across the system? You know, right now we have a lot of calls to undo the mark-to-market system. And we do not even know the full extent of the losses of the risky investments. To this date, we still do not know. And there is a lack of information of what that risk is that is posing one of the most significant underlying problems here.

What do you say to those who say let's undo mark-to-market?

Mr. LEVITT. I think we are entering a decade of transparency. Everything that we do, every rule that is made, every regulation that is considered for the next 10 years will be viewed in terms of is it transparent.

In that connection, I cannot possibly accept a notion of saying that the banks can take a product that may well be worth what they paid for it at the end of a certain period of time and consider that it is worth it right now. I believe in mark-to-the-market. I think the U.S. and global economies do have cycles. They did before we had mark-to-the-market accounting, and I think they will afterward. But it is not mark-to-the-market anything that created or made worse the cycles, including the present crisis. It was created by lenders making bad loans they could not collect on, thereby taking capital out of the system. Accounting has only informed the public of what those losses were. As loans began to reset after these unconscionable gimmicky loans were created and then securitized, as foreclosures grew more homes came into the market, and eventually supply overtook demand, depressing home prices at a faster rate. As losses got worse, as more homes went into foreclosure, accounting only informed the public that, in fact, it was getting worse.

So I understand the problem of valuing instruments that are so difficult to value, and there are no absolutes here. I think we have got to look to some way to deal with this, but I feel very strongly that mark-to-the-market is a principle that is so much part of an era of transparency.

Mr. LUDWIG. Senator, I agree with much of what the Chairman said, that is, Chairman Levitt. But there is clearly a problem here with mark-to-market accounting that has to be fixed, and the best way I could describe the problem is that if any of us had to sell our house in 24 hours and in this market we said, OK, I have got to sell my house in 24 hours, whatever it costs, somebody might offer you 10 percent of what your house is worth. To say that that house, your own house, which you may have paid $200,000 for, is now worth $10,000 because you had only 24 hours to sell it in a very bad market is not, in common-sense terms, the true value of that house.

Mark-to-market accounting by its term presupposes there is a functioning market. And the problem we have had over this really once-in-a-hundred-year cycle is that there has not been a market. So there clearly has to be honesty and transparency in our accounting principles, but what we cannot do is what you cannot do when there is no market.

One method that has been suggested in these kinds of circumstances that can be used is to cash-flow. If the loan is cashflowing, if you are getting payments on time, it is clearly not worth zero. It is worth more than that.

So this is an area, I think, that deserves some considerable study. We, of course, do not want to just throw the baby out with the bath water. But mark-to-market accounting when there is no market has not served wholly well.

Senator MENENDEZ. I understand that, and I——

Mr. LEVITT. It is not a simple matter, but my only thought here is that I think it would be a dreadful mistake for Congress to get involved in the standard-setting process. It is such——

Chairman DODD. I promise you we will not do that. I have fought that for years up here.

Mr. LEVITT. It is like base closings.

Chairman DODD. Don't go down that road.

Senator MENENDEZ. Well, I understand what you said, Mr. Ludwig. I am concerned—and maybe there is not a market at present, but those who advocate for its elimination are not talking about a temporary suspension or an adjustment. And that is the core principle. At the end of the day, part of what we have here was listening to the credit rating agencies and the lack of what they needed to do and the chain of the responsibility to investors here. And so in my mind, if you now cannot value—if you do not have a transparency as it relates to valuation, how do you ever make the right judgments, whether you are an investor, whether you are a regulator at the end of the day. And so there has to be some reasonable valuations that are real, not in the desired world but in the real world, because, otherwise, I think that is such a slippery slope that leaves the door open to revisit this set of circumstances again.

Mr. LUDWIG. I agree with you, Senator, and I agree with the Chairman that the Congress is very difficult to make accounting rules. That is why I said in my testimony I think we really need to look at the governance mechanism for how those rules are made. That I think is a very big issue. And right now the governance mechanism is not really closely tied to the policy-setting mechanism in Washington, and that is something I think ought to be considered.

Senator MENENDEZ. Let me ask one last question here. We saw a lot of efforts at self-regulation. You know, I mentioned in my opening statement the net operating rule, and then unlocking billions of dollars that were meant as cushions against loans that ultimately might go back. And then the cushion was gone, and then you had the set of circumstances where you used the banks' own computer models to determine risk instead of independently determining that risk and exercising the appropriate oversight as a regulator on behalf of investors and our whole financial market.

Shouldn't that be rejected as a potential form of regulation, self-regulation?

Mr. LUDWIG. I think that you have hit on something very important, Senator. There is a fox-in-the-henhouse issue that you are focusing on that just common sense, we all know that it has got to be monitored. And we have seen it evolve, and whether it is—it is in all kinds of self-regulatory proposals.

It is fine to have industry groupings and self-regulatory efforts. That is a fine thing. But you always have to have the referee, the cop on the beat, the independent party, the regulator that really controls at the end of the day the playing field. That is essential.

And, accordingly, something like Basel II has to, I think—the capital standard rule for banks—be looked at very, very cautiously as we move forward. So it really is the Government, the referee, that sets the standards with a bright line the people can rely on and industry can participate in that but should not be controlling it.

Senator MENENDEZ. I will just close. I cannot fathom for the life of me how if I have the responsibility—this is like the cop on the beat. You know, the reason we have police officers in our society is we expect everybody to obey the law. But the reality is not everybody does. And by the same token, it is a deterrent. We are maybe stopped at that red light, and we are very late for a meeting, and we are late for a meeting, and we are tempted to take it, but we do not because, No. 1, it would be violating the law; No. 2, you know, there may very well be a cop on the beat that is going to stop us. But if there is no cop on the beat to enforce the law, at the end of the day there will be people who will take the red light.

This is exactly what—in my mind, I do not know how you delegate the responsibility, the authority, and the oath to be a regulator and then to delegate that responsibility to the very industry that you are regulating. It is fine for them to have it as high standards internally for them to pursue. But in my mind, it is not right for the regulators to go ahead and delegate their authority at the end of the day.

Mr. LEVITT. I would agree that total delegation would be a mistake, but I do not know of any regulatory agency in Government that has the means to totally regulate their industries. And in a number of instances, many instances, self-regulation as an adjunct to the process of oversight, if there is appropriate oversight, is the very best way of doing it. The SEC could not possibly do the job that they do without the mechanisms of the NASD and the various stock exchanges. They have to be fast to crack down on them if they blow it, which they do periodically. But they are a useful adjunct, and I would not do away with——

Senator MENENDEZ. Would you have supported the net operating rule decision as it was pursued?

Mr. LEVITT. No, I would not have.

Senator MENENDEZ. Thank you.

Mr. STEIN. Senator, can I make one follow-up comment on that? I fully agree with that last comment that the regulators, even if they are empowered and even if they are motivated, which they have not been recently, are not enough to stop the abuses, which is why I mentioned the assignee liability in my oral statement, that they cannot do it alone. There are millions of transactions going on there. And what we know is that investment banks will not act against their financial interest if it would provide a sustainable loan for borrowers, and so we need the marketplace to police itself by putting incentives on the purchasers of loans as well.

Chairman DODD. That is a very good point.

I am going to leave the record—I have two or three quick questions. I wanted to point out, Senator Menendez asked a very good question and one that we have spent a lot of time talking about, and that is the mark-to-market or any changes in that. I presume people are aware of the SEC Office of the Chief Accountant and FASB, of course, which is the Accounting Standards Board, staffs on September 30th issued guidance to provide more flexibility on valuation under fair value accounting or mark-to-market.

For example, it said—and I am just quoting this here: "When an active market for a security does not exist"—as Gene Ludwig pointed out—"the use of management estimates that incorporate current market participant expectations of future cash-flows"—which you have also talked about—"and include appropriate risk premiums is acceptable."

Let me tell you, having worked on this Committee, I know in the past we had some very critical moments when people wanted to legislate accounting standards, and Congress has certain capacities. That is not one of them. And do I have rigorously opposed over the years to have Congress get involved in this. But certainly we ought to get involved if there is a standard here that is going in the wrong direction.

How do you quickly react to the guidance issue?

Mr. LEVITT. I think the guidance is an appropriate responsiveness on the part of the SEC to a very difficult problem. I do not dismiss the notion of the fact that at this time of opaqueness in our markets, where we are getting a surprise a day, a restatement a day, the signal being sent that we are suddenly giving up something as transparent as mark-to-the-market would be a mistake.

Chairman DODD. I agree. All right. That would be a total mistake in my view, and I agree with you on that completely.

Let me ask three quick questions and ask you to be brief if you could on them. Gene, you mentioned one thing earlier in your opening statement that I just wanted to pursue, and that is consumer protection issues. As I pointed out in my opening statement, in the past they have been sort of treated as nuisances from time to time, to put it mildly, and they have failed, I think, historically. And we have failed up here as well, I might add, in making the inextricable link between safety and soundness of our markets and consumer protection. We have treated them as if they were kind of separate things. One was sort of important, the other far less important.

I wonder if you might just comment on that nexus between consumer protection and the safety and soundness of our systems.

Mr. LUDWIG. Mr. Chairman, that comment is very wise, and I could not agree with it more. There is clear linkage between safety and soundness and consumer protection. After all, you could have called the standard in bank regulation "safety and safety," but they did not. They called it "safety and soundness." And what did soundness really mean when our forefathers put that word in? They meant something of high integrity, of probity. It was in the concept to begin with. It got lost. And in today's day and age, it is even more important that concepts of probity, of integrity, of compliance, of consumer protection be inextricably linked with supervision. And why? Because in a global environment where the consumer is more and more disassociated with this long chain of funding and of huge combines of institutions, faceless institutions, that consumer, that linkage, which is at the heart of a financial transaction, must be protected and must be part of the way the system thinks of a financial transaction. Because unless we do that at our regulatory mechanisms, these global huge enterprises will forget it.

So you are absolutely right. We have to make this linkage much tighter than we ever have before, and for the own safety of the financial institution. If you have a financial institution—take some of the ones that have been beat up in the press, say Lehman Brothers, and they are views as disreputable because they are selling disreputable products, it affects their base safety and soundness in a palpable way that has never been true before. So I could not agree with you, Mr. Chairman, more.

Chairman DODD. Let me ask quickly Mr. Stein and Mr. Rokakis this question. I raised in my opening statement, again, the issue of the HOEPA legislation in 1994 that required—it was not a request; it was a requirement—that there be regulations promulgated to protect against deceptive and fraudulent practices in the residential mortgage market, and nothing happened for 14 years. Let's assume nothing had happened for 10. If 4 or 5 years ago regulations had been promulgated—and look at the ones that came out this July. Let's just assume that is what sort of emerged. We will not try to pretend they are a higher standard, just the ones the present Fed has put out. Could we have avoided this mess we are in today?

Mr. ROKAKIS. Mr. Chairman, if you look at what happened in July, just look at the rules that were promulgated—prohibiting loans without regard to making good on that loan; the repayment of the loan; requiring creditors to verify income; banning prepayment penalties in the first 4 years of an ARM was involved; rules against the pressuring, against the coercion of appraisers—if those rules had been put into effect back when they went to the Fed, let's say 2001 or even 2002 or 2003, the outrageous lending practices that accelerated between 2003, 2004, 2005, and 2006 I think would have been prevented, or certainly slowed down, and I think we would be in a different position here today.

Chairman DODD. Mr. Stein.

Mr. STEIN. I agree. About half of all foreclosures now are due to subprime loans, which is about 11 percent of mortgages originated. And the problem with those loans is that people cannot afford them. Half of them were undocumented income. They had prepayment penalties that statistically increased foreclosure.

So, I agree, had those rules been promulgated even 4 years ago, a lot of the subprime foreclosures that we have seen—I would say the significant majority—would not have happened. It would not have addressed the Alt-A loans, which is kind of the second wave. We have a chart in our testimony of the resets. The subprime resets come first, and the Alt-A resets come after. That is why it is important for them to extend it to Alt-A, the protections to Alt-A, and the protections would not have helped that unless it changed the culture of originations.

Chairman DODD. Thank you for that. Let me jump quickly to one more subject matter.

Today's Wall Street Journal reports that, "Even after receiving an emergency loan that gave the Government an 80-percent ownership stake, American International Group, AIG, is spending money to lobby States to soften new controls on the mortgage industry."

The Journal goes on to report that State regulators say that, "AIG is currently working to ease some provisions in a new Federal law"—the one we passed this summer, in July—"establishing strict oversight of mortgage originators."

I assume that the provision referred to here is the mortgage originator licensing requirements, which I wrote into the Housing and Economic Recovery Act. And, by the way, Senator Mel Martinez, of Florida, a Republican member of this Committee, and Dianne Feinstein, the Senator from California, were the two who really argued very strongly—they deserve the credit, in my view, for pushing very hard for this provision to be included in the law. And so I want to recognize that.

Would any of you care to comment, first, on the appropriateness of a company whose very existence is dependent upon Federal largesse lobbying against a Federal consumer protection statute; and, second, whether mortgage brokers should be properly licensed, in your opinion?

Mr. LEVITT. I have difficulty with any company receiving Federal funds lobbying for any purpose.

Chairman DODD. Gene.

Mr. LUDWIG. This mortgage broker situation is really pernicious, Mr. Chairman, and what the Congress has done under your leadership is very important. It is one step in bringing back a regulatory framework for our entire financial system. The fact that we have parts of the financial system that have been un- and underregulated, that can drive the whole system—in good times they have extra benefits in capital, extra benefits in cost savings, because they do not have the regulatory safety net. But it drives the whole market in the wrong direction.

So you are to be commended, sir, for what has been done here, and anything to cut back on that is a very bad thing.

Chairman DODD. The other two of you?

Mr. ROKAKIS. Mr. Chairman, the destruction of the agency relationship, if you look at, I think, the three principal causes of this entire crisis, clearly deregulation at the top of the list, reliance on these complex, mathematical constructs that nobody really understands, yet Wall Street relied upon. But if you look at the destruction of the agency relationship, the fact that that broker sitting across from you is not working for you but is working against you, Mayor Morial talked about some of the other statistics. I think it is absolutely critical that we move in that area of regulation.

I also know that when there was talk about eliminating the yield-spread premium, this Congress was bombarded by, I believe, hundreds of thousands of calls and letters arguing against that. But I think it is that yield-spread——

Chairman DODD. It is not in those regulations that came out in July either.

Mr. ROKAKIS. No, it is not.

Chairman DODD. I feel very strongly about the yield-spread premium, and we are going to have that in our bill.

Mr. ROKAKIS. And I commend you for that.

If I might, Senator Dodd, there is just one thing, Mr. Chairman, and that is that I promised the housing counselors back home, the foreclosure counselors, that I would raise this point.

Chairman DODD. Yes.

Mr. ROKAKIS. Senator Casey touched on it, and I think it is so important, and we are going to look to you for leadership on this. We are being told now that we do not know what this format will look like when these mortgages get bought back, but we are being led to believe—we have been told that we cannot expect any additional leveraging or negotiating power once the Government steps in and buys these mortgages back because of the complex way in which these mortgages were held and sliced and because of the trust agreements in place and need to get cooperation from all the other bondholders. And I just have to ask you, if I could, Mr. Chairman, to please look more closely at this, because what Senator Casey has said is, in fact, true. We are getting a sense that the negotiations, which are so difficult—difficult? I run a program. We have done 4,000 mortgage saves since March of 2006. It is difficult as it is. It is often hand to hand combat. But the fact that we will have no additional leverage once these mortgages are purchased makes us very concerned.

Chairman DODD. Well, I agree. And, again, going back almost 2 years ago, as I pointed out earlier today in this hearing, in this very room, where around in the back of the room a large table was set up with all of the stakeholders on this issue, including most of these major institutions, many of which are not around today, unfortunately, but were holding an awful lot of these mortgages. Again, this gets into the weeds a little bit. But most of these mortgage-backed securities are contracts. And as I read and went back and really probed this very hard, the language allows for a lot of flexibility in working out those mortgages.

When they are trust agreements, it is much more difficult, and that will require maybe some legislation. But the good news is not many of them are trust arrangements. Most of them are contracts. And so I believe we have the authority under existing law for us to modify those mortgages. And it sounds confusing. It is not that confusing, and I think we do a disservice by suggesting this cannot be done. Somehow it can be. And certainly my intent would be—I would be furious to discover that we are going to make a strong effort here acquiring these mortgages, if you will, these instruments, and then not be in a position to do exactly what the legislation we drafted this summer is designed to do and which we set up for October 1 to begin the process, and that is to make it possible for people to get through the insurance.

So, look, you heard John McCain and Barack Obama debate this last evening, and that is the question of whether or not we do what they did in the 1930s, and that is where the Government actually purchased the mortgages. That idea had some appeal to me early on, and that is what they did in the 1930s. The difference is today we have the FHA. You can insure this. You do not have to go that route. And you can get a much better deal through this process at less cost. So while it is an appealing notion, I actually think the idea of actually buying these, as suggested, is not as attractive as the insurance idea is that we have included in the legislation this summer. But I am certainly going to insist that as we do this, we make sure that we have the ability to work those out.

Any other comments? Yes.

Mr. STEIN. Just to piggyback on that comment, when the Government buys some mortgage-backed securities, I do think that it is right to limit it compared to other investors in terms of requiring a modification, but the guarantee ability is there, and the other investors should like that.

And just on your question about AIG, I do think they should not be lobbying on that. My understanding of what they are trying to do is to say their brokers should be not licensed, they should be called an employee, even though they are really a broker. They are not a principal. And that just is kind of a ridiculous argument.

Chairman DODD. Yes. Well, listen, I wanted to ask and leave the record open. I know Members may have some questions, and I have some additional ones I will submit to you, and if you get a chance sometime in the next week or two to maybe respond to ones that you think you would have something to comment on, I would appreciate that very, very much.

Chairman DODD. We are going to have additional hearings, not just on what we have done here. As I said, I would have very much liked to have had Bill Donaldson and Chairman Breeden, who I have great respect for as Republican appointees to head up the SEC, did a very, very good job, in my view, and have had some very worthwhile comments to make over recent days on a lot of what we are talking about, more in the case of Mr. Breeden than Bill Donaldson. But it is important to hear from them as well.

What I said earlier to Mike Crapo, Senator Crapo, who has done an awful lot of work on regulatory reform, and I have a lot of respect for Senator Crapo, what he cares about, we are going to really look at that. That is going to require a lot of work, but I want to begin that process.

Then, also, what we need to be doing, and some good suggestions here today already, the things that we can do to minimize this kind of occurrence happening again. We will get out of this, and my hope is that what we have done already is pointing us in that direction. And even though the markets do not reflect that from day to day, there are a lot of other things occurring that I think are still causing people to be very skittish and frightened about getting back into the market.

But I think we are on the right path, and I believe very strongly that investors and the American consumer can have far more hope and confidence we are going to get there than they certainly have felt over the last several weeks. You may not see it today, and it is not going to blossom all at once. But we are on the road to getting this right again, in my view. And so I do not want a hearing like this to end without having some sense of hope and opportunity and confidence.

As Franklin Roosevelt said so eloquently more than 80 years ago, it is fear, and that fearing fear is what has, I think, had an awful lot to do with the lack of confidence in our country, and we need to get our confidence back. And I think we are on the road to doing that, and your testimony here today has helped us, I think, get rid of some of the myths and talk about the real problems we need to address, and I am very grateful to all of you.

The Committee will stand adjourned.

[Whereupon, at 1:15 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

TESTIMONY OF ARTHUR LEVITT, JR.
SENATE BANKING COMMITTEE; WASHINGTON, DC
15 October 2008 – Submitted to the record

Thank you, Chairman Dodd and Ranking Member Shelby, for the opportunity to appear before the Committee at this momentous time in the life of our markets.

Seven decades ago, this Committee conducted hearings similar to these in a situation eerily reminiscent of the situation we now find ourselves in.

Between September 1, 1929 and July 1, 1932, the value of all stocks listed on the New York Stock Exchange fell from nearly $90 billion to just under $16 billion – a decline of 83 percent. The value of bonds listed on that Exchange declined by 37 percent, from $49 billion to $31 billion.

"The annals of finance," the Senate Banking Committee memorably would write, "present no counterpart to this enormous decline in security prices."

Seventy-six years later, we now have that counterpart, and like then, today everything must be on the table. No notion is unreasonable. No idea is unthinkable.

The unthinkable has happened – we are in the worst market crisis I have seen in my forty-plus years in and around the markets -- and we must be creative and daring in order to get our markets working again.

To do this, we must examine what went wrong.

From where we stand at this moment in the crisis, we already know that there is plenty of blame to go around: the banks and mortgage brokers who first made these loans. The financial engineers on Wall Street who securitized them. The credit rating agencies who gave AAA ratings to mortgage-backed securities that they helped to construct. The insatiable appetite of some investors that blinded them to the risks involved.

Let me be absolutely clear about one point. We are here today not because of what happened this year or last, but because of at least two decades of societal and political adherence to a deregulatory approach to the explosive growth and expansion of America's major financial institutions.

Furthermore, it is now readily apparent that our regulatory system failed to adapt to important, dynamic, and potentially lethal new financial instruments as the storm clouds gathered.

The list of failures goes well beyond the Securities and Exchange Commission, but today I want to focus my remarks on that agency.

In doing so, let me stress that there is not one individual action or decision made by the SEC that deserves to be singled out for blame. It's how a series of decisions made and actions taken – and not taken – contributed to a market failure and then meltdown.

Remember that financial markets are not naturally occurring phenomena.

They are the creation of men and women, and as a result, for them to be "free," men and women must construct the rules and oversight necessary to give potential participants the confidence to enter these markets. They must lay down clear rules of the road that open the marketplace to all and that bring a high degree of transparency so investors of all sizes can get the information they need to make the best investment decisions with the confidence that information is not being selectively shared. And they must establish an entity to enforce these rules of the road rigorously, fairly, and swiftly.

Taken together, this independent regulation and strong regulatory enforcement create the trust that is a necessary precondition for a free and functioning market.

Let us not forget that regulation is not inconsistent with free markets and financial innovation. Strong regulation ensures that the system supports and fosters such innovation by ensuring that the financial system earns and sustains the trust of investors.

Right now, the key problem plaguing our markets is a total breakdown in that trust – in investor confidence.

Investors and lenders of all sizes and types have little faith in the information they have been given. Little faith in the gatekeepers tasked with protecting their investments. And little faith in the regulators to hold anyone accountable for misusing those funds.

That is why $7 trillion in market capitalization has been wiped out; why investors are cashing out of the markets entirely and effectively stuffing their cash in their mattresses; and why the credit markets have been crippled.

Since 1934, the SEC has played the role of the investor's advocate in our markets...the guarantor, if you will, of investor confidence.

Created in a crisis similar to what we are now experiencing, the SEC was founded precisely to start rebuilding the trust lost in the Crash of 1929. Congress believed that the financial markets needed a specialized agency, with clear enforcement powers, to insist on full disclosure of all material information, and most of all, to end the loopholes that frustrated the ability of the states and the stock exchanges to enforce rules designed to prevent fraud, market manipulation, and insider trading.

For most of its nearly 75 year history, a strong SEC – staffed by consummate professionals and led by independent-minded commissioners – has succeeded in restoring investor confidence and helping making our markets the envy of the world.

Consider the numbers: in 1930, 1.2 percent of the population owned stock; in 2008, the number was a little more than 30 percent – and tens of millions more indirectly invest in our securities markets through retirement accounts and mutual funds.

Unhappily, over the past few years, the SEC has not lived up to this storied history.

As the markets grew larger and more complex – in scope and in products offered – the Commission failed to keep pace. As the markets needed more transparency, the SEC allowed opacity to reign. As an overheated market needed a strong referee to rein in dangerously risky behavior, the Commission too often remained on the sidelines.

As this Committee examines the past, I believe it will find a lack of transparency, a lack of enforcement, and a lack of resources all played key roles.

Lack of Transparency

Being able to gather and understand relevant information about a company's financial health and performance is critical to the proper functioning of the markets. If people believe the numbers, they will believe that their investments will be made by their best judgment.

If they do not, they will not invest.

That's why transparency is so important to restoring trust and why we need to dedicate ourselves to a decade of transparency – improving transparency to win back investor trust.

Looking back, transparency was certainly lacking with respect to the off-balance sheet transactions involving Structured Investment Vehicles, the latest version of the Special Purpose Entities used by Enron to mask its true performance and risks.

In the text of Sarbanes-Oxley, Congress rightfully asked the SEC to study the issue and work with the FASB to fix this shortcoming in transparency. Unfortunately, they did not, and these accounting methods were used once again to mask the financial health of many companies. Financial firms were not transparent to shareholders. These vehicles must be brought on the balance sheet immediately.

Fannie Mae and Freddie Mac also engaged in creative accounting making it appear they had capital that just did not exist. At the time of the government takeover, for instance, Freddie Mac had $34.3 billion of paper losses on mortgage-related securities that it did not count toward its calculations of capital requirements; and Fannie Mae had $11.2 billion of such losses. Fannie and Freddie were not regulated by the SEC, but by a regulator who lacked adequate supervisory and enforcement authority and the results were clear.

Even today, we do not know the full extent of the losses from these risky investments; as a result, a lack of information about where risk resides is keeping investors suspicious and out of the markets.

One of the biggest steps we can take to bring to light a fuller picture of companies' financial health would be to expand fair-value accounting to cover all of the financial instruments -- the securities positions and loan commitments -- of all financial institutions. Fair value accounting has been called for by the United States Comptroller, the head of the GAO, the Chairman of the Federal Reserve, and the CEOs of every major American accounting firm since after the savings and loan crisis. Such action has been implemented at a dangerously slow pace.

In recent weeks fair-value accounting has been used as a scapegoat by the banking industry – the financial equivalent of shooting the messenger. If financial institutions were accurately marking their books, they would have seen the problems they are experiencing months in advance and could have made the necessary adjustments – and we could have avoided the current crisis.

Instead, we are still left in the dark as to the full extent of the damage.

The IMF and Bridgewater Associates have pegged the losses from those risky investments to be approximately $1.4 to $1.6 trillion. Yet according to one estimate, less than half of these losses have been reported in financial statements provided to investors.

And as another measure of how unrealistic these balance sheets are, recall the latest deal for Wachovia. Its book value – assets minus liabilities – was reported to the public at $75 billion. Yet, it was bought by Wells Fargo for $15.4 billion, a discrepancy of $60 billion dollars. That's a huge disparity that mirrors the size of the credibility gap in financial reporting. Until holes like this in financial reporting are filled, investors will not return to the markets.

A lack of transparency has also hurt the market for credit derivatives, a market that grew to over $62 trillion in value but with only $6 trillion in actual loans.

Credit default swaps themselves are not bad; in fact, they serve an important purpose as hedges for bondholders. But when they are abused by those who don't own bonds and who use rumor and innuendo to affect the market, serious problems occur that reverberate throughout the system. Indeed, regulators and investors alike have been unable to get their arms around the magnitude of the risks this market has created for companies and investors alike – and this lack of information has now paralyzed the economy.

In response, we need to bring this market into the sunlight. It's time that the SEC is given the authority to establish regulation of credit derivatives including giving the regulator the necessary authority to enhance the transparency of the disclosures and markets for these transactions.

Likewise, there must be greatly improved disclosures for credit derivatives including disclosure of notional amounts, a roll forward of notional amounts as well as fair values of the derivatives, the terms and conditions that can result in a call for collateral, the weighted average duration of such contracts, and information regarding the counter-party risk involved.

In addition, we should demand the disclosure of key indicators of future performance, especially those that can have an effect on liquidity and capital, by public companies – a move backed by the major international accounting firms.

Lack of Oversight

As the markets grew more complex, there also was a failure of oversight to keep up with growing and risky parts of it.

After the Supreme Court's 2007 ruling in the *Stoneridge* case, the SEC could – and should – have pushed Congress to establish third-party liability in cases where knowing, fraudulent conduct has occurred and destroys trust in the capital markets. Yet, they did not. Instead, investors were left with the sense that they could be taken advantage of with impunity.

In 2005, the banking and securities regulators recognized the risks inherent in the credit derivatives market when they convened a meeting of institutions and regulators at which they expressed concerns about the market, trading, and lack of internal controls. Yet the credit derivatives market remains unregulated today with enormous risks.

In 2004, the SEC adopted new CSE rules, in part due to a lack of authority granted by Congress, to revise the supervision and capital requirements for investment bank holding companies.

The program – a voluntary regulatory program for our largest and most complex investment banks – was, in the words of Chairman Cox, "fundamentally flawed."

And as the report of the SEC's Inspector General detailed, it appears that in at least one instance -- the case of Bear Stearns – the SEC failed to act on the many red flags that showed the bank taking on unacceptable and unrealistic levels of risk. There was, simply, a fundamental breakdown in oversight – one that allowed the collapse of companies representing more than 40 percent of the CSE's original membership

This program has been shut down, but the Congress should give the SEC enhanced authority to regulate investment banks as well as the credit rating agencies. And any question regarding the authority of the SEC to regulate hedge funds should be resolved quickly through appropriate legislation.

In addition, the SEC also has failed to empower investors with what they need to hold managers and boards accountable.

Because of purposeful action and inaction, American shareholders do not have access to the proxy or a say on pay. These boards represent the shareholders. These executives work for the owners of the company, the shareholders. And with a carefully designed system to prevent abuse, there is no reason why shareholders should not be able to hold directors and managers accountable.

Mutual fund investors also have been left with boards of directors who are not suitably independent.

And millions of Americans have their retirements through their pensions invested in hedge funds – many of which are not regulated at all.

To regain investor confidence, timely action must be taken on each of these matters. The Senate should adopt legislation on say on pay, as the House has, and the SEC should adopt proxy access and rules governing regulation of hedge funds as well as the independence of mutual fund boards.

Finally, based on my own experiences with an investigation of the City of San Diego, I believe Congress should repeal the Tower Amendment, giving the SEC the same oversight responsibility and authority over municipal markets it has over the stock markets.

The capitalization of these markets now runs into the trillions of dollars, face many of the same risks faced by other markets, and as we have seen from a number of SEC enforcement actions this decade, are subject to the same abuses as other capital markets.

Simply put, they are too important to leave unregulated. If we do, we risk yet another crisis.

Lack of Enforcement

The last area where we have seen a deviation from decades of SEC history, tragically, has been the enforcement of the laws on the books.

In part, this is the result of a lack of adequate resources. Budget and staffing levels have not kept pace with inflation or financial innovation.

The Enforcement division is slated in FY 2009 to be more than 11 percent smaller than it was in 2005 – a little more than the percentage decrease in total SEC staff.

This critical part of the SEC also has been unnecessarily hamstrung in negotiating corporate penalties because of recent procedural changes at the Commission. The result has been a lessening of the imposition of corporate penalties against egregious wrongdoers, a reduction in the corporate penalty numbers over the past year, and a demoralizing of the enforcement staff undermining their efficacy.

To remedy these deficiencies, we – at the very least – need to return the SEC to previous staffing and resource levels. To that end, an increase in appropriations of $85 million would be a good starting point.

And in choosing future commissioners, priority should be given to individuals identified with investor interests rather the traditional choices of securities lawyers, exchange chairmen, and academics. Investors need a seat at the table.

Restoring Trust

Resources alone will neither reinvigorate the SEC nor revive our markets.

Enforcement is so important not because the SEC can catch every cheat and prevent every abuse.

It's important because it holds people accountable and serves as a powerful deterrent to bad behavior – and is the most powerful tool a regulator has to keep a market functioning.

Indeed, the signals the SEC can send to investors are critical. By bringing a tough enforcement action, making a well-timed public statement, or taking action on a critical need, the SEC builds the investors' confidence that someone is looking out for them which, in turn, builds market trust.

Yet at critical moments and on critical issues, the SEC has been reactive at best or has shown no real willingness to stand up for investors.

And it's these moments that weaken the power of the agency and investors' faith in the markets.

What regulators quickly learn is that more important than any rule that can be written, regulation that can be passed, or standard that can be set is the power of the bully pulpit.

For the past 75 years, the SEC has been the crown jewel of the financial regulatory infrastructure and the administrative agencies because its leadership, representing both political parties – like Kennedy and Douglas at the SEC's founding, and Ruder, Breeden, and Donaldson in recent times – understood the importance of public pronouncements and signals sent to the marketplace.

They recognized the important role the SEC plays in maintaining investor confidence and in keeping our markets functioning. And they knew that being present and active often was the reassurance that investors needed.

Looking forward, restoring trust in our markets will require rejuvenating the SEC. It is the only agency with the history, experience, and specific mission to be the investor's advocate.

Losing that legacy would be devastating to our ability to regulate the markets and restore investor confidence.

But let me be clear: a restoration of the SEC to its position from before this current slide is not enough. At this moment, we need a dramatic rethinking of our financial regulatory architecture – the biggest since the New Deal.

The markets and the financial system have profoundly changed, and that will undoubtedly mean the SEC will need to undergo changes and evolve to keep pace with the marketplace.

But as we move forward in the process, we must make sure that there is an agency that is independent of the White House, dedicated to mandating transparency with robust law enforcement powers and with wherewithal and knowledge to oversee and if necessary guide risk management, and built around one mission: protecting the interests of investors.

For 75 years, that agency has been the SEC, and I believe that if we restore that legacy to the SEC and modernize it for today's markets, investors will know that they have someone in their corner, that the markets will be free and fair, and that they will invest with confidence.

And once that trust is restored, I believe that we will come through this crisis – as we have come through many other market crises in the past – with markets that are stronger and more robust and with an economy that benefits from them and benefits us all.

Thank you.

WRITTEN STATEMENT OF

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Before the

SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

October 16, 2008

Mr. Chairman and members of the Committee, I commend you for your leadership in holding these critically important hearings on the origins and impact of the crisis that is enveloping financial institutions and financial markets worldwide—the most serious since the Great Depression. Understanding the root causes of our predicament will allow us to restore our economy and install a regulatory framework that can withstand the challenges of technology-driven, 21st century finance.

I am honored to testify before your Committee, Mr. Chairman, to contribute my thoughts and to answer any questions you have.

Introduction

The increasingly painful and heart-stopping developments in the U.S. and global financial systems are not the result of mere happenstance. We are in the midst of a historic sea change, particularly in American finance, indeed in the direction of the American economy itself. The paradigm of the last decade has been the conviction that un- or under-regulated financial services sectors would produce more wealth, net-net. If the system got sick, the thinking went, it could be made well through massive injections of liquidity. This paradigm has not merely shifted—it has imploded.

This paradigm implosion is rooted in fundamental imbalances in our economy and financial system, as well as regulatory structures and crisis response mechanisms that are outdated, including importantly:

- Consumerism run riot, made worse by domestic fiscal laxity and modern financing techniques;
- A deterioration in market conduct, brought on by a short-term profitability horizon, aided and abetted by technology and globalization;
- A regulatory hodge-podge involving absent or inadequate regulation of the predominant portion of our financial system and pro-cyclical policies that have not been well conceived; and
- A misguided belief that in financial storms we should let bare knuckled free market capitalism as opposed to compassion and balance rule the day.

By understanding these root causes of our predicament, we can rebuild from the ashes of the current burnout.

Discussion

Rampant Consumerism, Structural Imbalances and Modern Finance: For decades we have looked to the consumer as the key driver of our economy. Taken in proportion this is a good thing. However, this dependence on the consumer has been a losing proposition on its face, given that since 2000, median family income, adjusted for inflation, has been declining. Nevertheless, consumerism has been taken to an extreme, propelled by policies that have resulted in a negative savings rate of historic proportion. Policy makers' excuses that negative savings were not a problem because home prices were rising only caused the consumer to dig a bigger hole for himself. Home and hearth became the consumers' ATM machine as home equity and other consumer loans, leveraged the American consumer to the hilt. Such excess would inevitably lead, as it did, to a financial wildfire.

The actual sparks that ignited the fire began to fly in the early months of 2006. It was at this moment when house prices begin to level off and fall while at the same time there was an explosion in the use and availability of novel, low-quality mortgage instruments designed to "help" consumers pump every dollar possible out of their homes.

Our grandparents' generation would have recognized the "help" consumers were getting from financiers and from government for what it was. Consumers were not being helped. They were being enticed to mortgage not just their homes but their futures and the future of their children on national and personal deficits based on thin promises. The notion that home prices would climb forever and that we could spend our way to financial and national success was accepted unblinkingly. Interest rates held too low for too long, excess liquidity, and structural fiscal and trade deficits based on an imbalanced tax regime benefited the sellers at the expense of those who really could not afford what they were buying.

And this excess, this lack of sound standards of "buy what you can pay for," was turbo-charged by the plentiful oxygen of model-driven, structured financial products. Importantly and unfortunately, these highly leveraged products, based on misunderstood and often inaccurate ratings, were distributed throughout the world. Derivatives with even thinner capital bases were in turn piled on top of this mountain of structured products. Acronyms for plain old excessive, under-regulated leverage – SIVs, CDOs, CDOs, squared, swaps, swaptions— lulled us into a false sense of high-tech financial complacency.

Deterioration in Market Conduct: A second major area of failure that brought on the current conflagration has been a marked deterioration over the last several years in market conduct by too many financial services players—mostly, but not only, the un- and under-regulated financial intermediaries. So mortgage brokers sold consumers mortgages that were too often inappropriate for their circumstances in exchange for outsized fees. More heavily regulated financial institutions sliced, diced and bundled the inappropriate mortgages, selling them off to other intermediaries or end purchasers, feeling no compunction because they held no principal risk.

This turn away from traditional relationship finance based on customer care and high integrity standards has been facilitated in part by the increasing financial use of technology and by globalization. Through increasing speed and scale, the face-to-face linkage to the consumer has been attenuated. This has made rules fashioned for a bygone era harder to apply.

Finance is in many ways an information business and the technological revolution we have been living through has been essentially an information technology revolution. The computer has allowed global connectivity, mathematical/financial modeling, and savings to scale that have created entirely new financial products, and allowed, if not driven, rapid and extraordinary consolidations and concentrations, on a global scale unthinkable a few decades ago. It has also placed financial firms further away from the end-use consumer.

In a sense, technology, plus globalization, plus finance has created something quite new, often called "financial technology." Its emergence is a bit like the discovery of fire—productive and transforming when used with care, but enormously destructive when mishandled.

Like anything new and dangerous, we should have handled this financial technological fire with great care, with appropriately cautious regulation, with concerns about those—particularly low and moderate income Americans—who were touched by it but by no means understood it. But instead of more cautions regulations in this new more dangerous era, we took the regulatory lid off.

Regulatory Hodge-Podge. Over approximately the last decade the country has been in the thrall of a deregulatory viewpoint which has left us with too few financial regulatory firefighters too far away from where the fire started and where it has burned the hottest. We have allowed a huge portion of our financial system (perhaps as much as 80%) to go un- or under-regulated. Indeed, going into this crisis, official Washington not only did not know where all the pockets of mortgage-related risk were, they did not know the magnitude of the risk itself.

At the same time, the regulated portion of the system has been unevenly regulated. Some aspects of bank regulation, for example in the anti-money laundering area, have been very heavily regulated with tens of millions of dollars of fines and enforcement actions being piled on enforcement actions for the same wrong. Other aspects of finance, for example, credit standards, securitizations, suitability of products for customer usage, have been markedly less strictly regulated.

To add insult to injury, as a result of history and not logic, we have a bank and securities regulatory system that has been unflatteringly referred to as the "alphabet soup" of regulators. This alphabet soup has exacerbated the problem of overregulation in some areas and created gaping holes in other areas. (For example, the "special investment vehicles" or "SIVs" where a great deal of the bank subprime mortgage risk resided were off-balance sheet bank holding company constructs that essentially went unregulated.)

As if this were not enough, over the past decade we have allowed a number of pro-cyclical and largely untested policies to grow up that are wholly inappropriate and way too rigid. What I mean by "pro-cyclical" is that regulatory, accounting and policy standards and practices tend to move in the same direction as the broader economy. The result is a sort of amplifier effect, in which both good times and the bad times are reinforced as their effects are rapidly transmitted through the economy. One way to think about it is that the failure of our regulatory, accounting and policy standards and practices to exert a moderating influence at all times is what makes the highs so high and the lows so low. While pro-cyclical bias sounds rather abstract, it is a real weakness of our financial system with which policymakers must grapple. In some nations, such as Spain, regulatory policy is deliberately designed to be counter-cyclical, to serve as a countervailing influence on the economy, and these policies merit closer analysis.

How does pro-cyclical bias present itself in clinical terms? We see it in our accounting rules. The concepts around mark-to-market accounting and the relatively recent reliance upon accounting formulas instead of judgments in establishing loan loss reserves clearly added to the financial catastrophe. Mark to market accounting by definition cannot work when markets cease to operate correctly. Likewise, we have relied on rigid new accounting rules and models to set loan loss reserves with a mark-to-market methodology that has left the reserves too thin to do their job in difficult times.

More subtle, but of even greater importance, is the accounting governance mechanism that disconnects accounting rulemaking from business and economic reality, as well as from the public policymaking framework. This has resulted in some rules that run contrary to the time-honored principle that accounting should reflect, not drive, economic reality.

Every bit as important, perhaps more important even than our off-kilter accounting rules and rulemaking, is that our regulators have allowed short-term pressures to rule our financial institutions. Compensation schemes, too, have rewarded executives for short-term results. All of this has forced our financial institutions, their senior executives and their boards to "keep dancing" when times were good even though they knew in their hearts that the music would stop with a thud.

Further, Basel II capital standards, though less of an obvious cause, are certainly not a help in these troubled times. Basel II Pillar 1 is itself too new, too pro-cyclical, too complicated and model-driven. There is no evidence that it in any way helped in this crisis. And there is evidence that it was overly pro-cyclical.

To summarize, gobs of liquidity, consumers on a binge, new highly combustible financial tools, and little effective and overly pro-cyclical regulation has resulted in a financial firestorm. It is as if the modern tools of finance were used to create their magical new fire of finance in the center of a living room, filled with highly combustible furniture, not in a properly designed fireplace.

Response to the Turmoil Too Little Too Late. To add insult to injury, the response to the rising heat of the fire was a series of too little, too late steps based on an ideology that the market could take care of itself. Bureaucracies proved less flexible than was necessary. Our responses to the conflagration were typically taken after the next fire broke out, not before.

The capstone of this initial phase of the effort was the decision to allow Lehman Brothers to fail. To my mind this is what started the financial panic, egged on by the failure to support the preferred stockholders in the Fannie and Freddie nationalizations and the decision to treat AIG so differently from Lehman Brothers.

And the panic got out of control because we have allowed short sellers and rumor-mongers to roil instead of calm the markets on the one hand, and have not had sufficiently flexible circuit breakers to give the markets a bit of a time out on the other.

So where do we go from here?

Short-term relief: The TARP, the liquidity facilities being created by the Federal Reserve, and the nationalization of parts of the financial system will ultimately get the economy under control. The key is for the Fed and the Treasury to act vigorously and liberally with the use of these facilities—to remove the much-discussed stigma of seeking government support. And I still worry that there is a disconnect between policy and bureaucracy, one that can and should be bridged with great haste. However, the cost to the country has been and will be great. And we will have historic choices to make.

It is clear that the deregulatory mantra of the last decade is dead. The real question is how far do we go in terms of regulating the financial system. Do we in essence nationalize it, making banking all but a public utility? I fervently hope not. But we have to massively change how we have been regulating and supervising. We have to take better control of the revolutions in technology and globalization. We have to get the fire back in the fireplace.

A New Framework: In order for America to enjoy the benefits of a modern financial system that can allow it to more readily help to build new factories, hospitals, schools and homes, we need a new regulatory framework, one suited to technology-driven finance of the 21st century. Certain elements of that framework are clear.

1. Sound finance must start with fair treatment of the consumer and much higher standards of market conduct. We cannot allow any American to be knowingly sold inappropriate financial products as has just taken place too often in respect of sub-prime and "alt-A" mortgage products. For all the good we are doing to bolster the financial system, we will have won the battle and lost the war if we fail to redouble our commitment to keeping homeowners in their homes.

2. All financial enterprises should be regulated within a unified framework. In other words, financial enterprises engaged in roughly same activities that provide roughly the same products should be regulated in roughly the same way. The same logic must apply to institutions of roughly the same size—they should be under roughly the same regulatory regime. Just because an institution chooses one charter or one name does not mean it should be able to manipulate the system and find a lower standard of regulation.

3. The U.S. must abandon our alphabet soup of regulators and create a more coherent regulatory service. We have a system that is rooted in a proud history, that includes exceptionally fine and dedicated public servants, and that in many ways has served us well. But it is now beyond debate that a banking framework with its roots in agrarian, 18th century America is in urgent need of a radical, 21st century, global-economy restructuring. However, the secret to effective regulation is not how we move around the boxes. Mashing the alphabet noodles into one incoherent glob will not make the concoction taste any better. What we need is a much more effective regulatory mechanism. We have to take the whole effort up a notch. We have to put the time and energy into determining both what regulations are

effective, and what regulations place pure counterproductive and bureaucratic burdens on institutions.

4. We need to professionalize financial services regulation. We have college degrees for everything from carpentry to desktop publishing to commercial fishing, yet we do not have full courses of studies, degrees, chairs at major universities in supervision and regulation. America is in fact blessed with many talented and dedicated examiners and regulators, but this is in too large a measure despite, not because, of our system of on-the-job training for the guardians of our financial system.

5. We need to deleverage the financial system and country as a whole and restrain excess liquidity build-up. In this regard, we have to encourage savings, eliminate the structural federal budget deficit and contain asset price bubbles before they get so large that pricking them brings down the economy.

6. We must reverse the tendency of the last decade to have pro-cyclical regulatory, accounting and other policies. Mark-to-market accounting is clearly flawed and must be materially re-worked.

7. Finally, we need to align financial rewards for executives with the well-being of their companies and the stakeholders they serve. Clearly, financial institution governance is off kilter when we give a king's ransom to traders and other financial executives who have in essence beggared their companies and then walked away from a shipwreck to a comfortable retirement. At the same time, executives who take the wheel, stay with the vessel, and steer it through stormy seas deserve to be fairly compensated.

These are but a few elements of what must be a greatly changed financial services system. I have also submitted for the record a lecture I was asked to deliver on this topic recently before the International Conference of Banking Supervisors, which provides a more detailed description of my thoughts on how a new financial services regulatory system would look and function. For America to continue to be a leader in the world and for finance to serve the needs of our people, we cannot wait. We must start now to learn from our mistakes and rebuild.

Remarks of

Eugene A. Ludwig

Founder and CEO, Promontory Financial Group

William Taylor Memorial Lecture
Delivered to the International Conference of Banking Supervisors
Brussels
September 25, 2008

I am deeply honored to be here today to deliver the 10th William Taylor memorial lecture. The collective wisdom in this room is without peer in the area of supervision and regulation. But even more than the wisdom, it is the dedication of the people here today that is most impressive, dedication that sacrifices personal gain for the possibility of a better world order, one where greater financial and economic stability, means greater wellbeing for every world citizen. And, I would add that you, Paul Volcker, stand primus inter pares as well as altimus inter pares.

It is this combination of intelligence and dedication that also characterized Bill Taylor. I knew Bill Taylor well, and I can attest from firsthand experience to the intelligence, integrity, fairness and public spiritedness of this fine man. Most notable to my mind was Bill's practical intelligence that strove energetically to get to the bottom of things without artifice, a trait shared by the very best in the supervisory profession.

In reading again the words of the nine distinguished central bankers and bank supervisors who gave this lecture before me, I was struck by how many of the talks were reflections on a recently passed financial crisis. So it is that we meet once again in troubling times. Some say this is the most difficult period for financial institutions since the Great Depression.

The superficial analyst will explain away the troubles of today as the result of chicanery. But, I know all of us in this room recognize the problems this crisis exposes are much more fundamental than that. The turmoil raises difficult questions about many of the building blocks of modern finance – models, ratings, structured finance, leverage, collateral, and diversification.

Some will say, though perhaps not in our presence, that in fact the current financial turmoil shows that our old art of regulation and supervision does not work or, at least in a modern world, cannot work well enough. Others will say that the costs of regulation and supervision are just not worth it because in a financial storm, the only thing that really matters is governmentally controlled financial largesse – i.e. monetary policy, discount windows and the like. Finally, by implication at least, some have said that regulation and supervision should in reality be a second-class citizen in governments' arsenal of financial controls, something of a stepchild of central bank activity.

These attacks on supervision are largely specious. As I will elaborate on in a minute, excessively liquid markets and un- and under-regulated sectors of the financial services industry have been the primary drivers of today's financial turmoil. In fact, serious supervision of the entire financial services marketplace, particularly of the sectors most involved in the crisis, would have at least mitigated the impact of the crisis. One of the great strengths of regulation and supervision is that good supervision is all about facing up to the reality of the situation, calling it accurately as best we see it, without political, theoretical or some other shading. The integrity of the supervisory process allows markets to clear, to remain in operation, and to rebuild.

However, the truth is that at least elements of the supervisory mechanism of today, along with other private and public sector participants in the financial system did not fully anticipate and adequately moderate today's financial system woes. Accordingly, this is a time for all of us to be deeply reflective and to learn.

Today, I want to say a few words about lessons that we can learn from the current crisis and how this should inform our evolution towards a more robust regulatory architecture. I realize that this is presumptuous of me, as a former regulator from the country that has been at the epicenter of the current storm. But, if we do not learn from history, including from our forbearers, we do not learn at all.

It bears emphasis that these lessons apply to supervisory systems large and small. Globalization means that every economy is threatened when something as big as our present problem emerges. On this occasion, the underlying health of the main emerging markets is thankfully much better than, say, in the early 1990s. But recession in the G7 has knock-on effects for every economy round the world and therefore we all suffer in the long run when, as happened early in this decade, there was a weakening of underwriting standards for subprime mortgages in the US.

Accordingly as I embark today on an effort to outline both key lessons learned and elements of the supervisory architecture of the future, I do so recognizing that with all humility this is just one man's view and that much of what I have to say is made possible because I am able to stand on the shoulders of leaders past and present.

With that said, off we go.

Lessons Learned

The fundamental story of the current turmoil is relatively easy to tell. It began early in this decade with a weakening of underwriting standards for subprime mortgages in the U.S. Subprime, alt-A and other mortgage products were sold to people who could not afford them and in some cases in violation of legal standards.[1] Licensed

[1] Financial Stability Forum. "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience." Apr. 7, 2008. <http://www.fsforum.org/publications/r_0804.pdf>, 36; and Joint Forum of Basel Committee on Banking Supervision. "Credit Risk Transfer: Developments from

but only cursorily regulated mortgage brokers originated the worst of the paper, and drew the marketplace toward lower standards.[2] Originators typically did not hold onto the paper, but passed it along to mortgage banks and others, who sliced and diced it into tranches and packaged the tranches into some relatively new and previously untried structured securities. It was generally believed that only the ultimate holder of the securities retained any material risk.[3] While the rating agencies rated the securities using mathematical models, and others along the distribution chain modeled the risk as well, it is widely accepted that there was insufficient data and faulty assumptions.[4] Compensation incentives were principally about profit and neither about customer relationships nor about compliant behavior.

Lessons 1, 2, 3, 4, 5, 6 & 7.

1. New untried instruments, like new businesses, carry higher risk and should be more carefully regulated and supervised, particularly where they are used extensively, carrying perhaps a greater capital charge, greater reserving and/or being subject to concentration and growth limits.[5] Such instruments should also be subject to reporting requirements, so regulators can monitor the market implications.[6]

2. Models are tools that can add value but are not wholly reliable and must be tested and understood by financial institutions that use them.[7] Over the past decade there has been a growing reliance on models by financial firms and regulatory agencies.[8] Regulators should enforce higher standards of model validation and governance, including verification that management actually

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2005 to 2007." Bank for International Settlements: July 2008. <http://www.bis.org/publ/joint21.pdf>, 12.

[2] Joint Forum, 12.

[3] Joint Forum (2008), 20-24; and Padoa-Schioppa, Tommaso. *Licensing Banks: Still Necessary?* William Taylor Memorial Lecture 5 presented at the International Conference of Banking Supervisors in Washington, DC. 24 Sep. 1999. <http://www.group30.org>

[4] Joint Forum (2008), 19.

[5] Financial Stability Forum (2008), 40 and Joint Forum (2008), 28.

[6] Joint Forum (2008), 24.

[7] Crockett, Andrew. *Banking Supervision and Financial Stability.* William Taylor Memorial Lecture 4 presented at the International Conference of Banking Supervisors in Sydney, Australia. 22 Oct. 1998; and Joint Forum (2008), 28. <http://www.group30.org>

[8] Financial Stability Forum (2008), 19, 27; and Joint Forum (2008), 10, 13, 24-29.

understand the models they use.[9] Regulators should insist that models take into account tail events and that a significant margin for error is built into model usage, as models can never be 100% predictive and are typically captive of available historical data and the assumptions used in their construction.[10]

3. Similarly, near-exclusive reliance on rating agencies is mistaken. Rating agencies have an important, value added function of course but, like all human constructs, they do not have clairvoyance; they too make mistakes.[11] Financial institutions should do more than merely rely on third party rating agency evaluations, particularly of large positions.[12] The larger the position, the more extensive a firm's own risk assessment efforts should be.

4. The securitization process has lulled regulators and financial firms into a false sense of comfort in terms of risk relief for those who are in the securitization chain but who do not ultimately hold securitized paper.[13] Worse still, we have today turned every transaction in our capital markets into a quote-unquote "trade." People, customers, relationships are secondary if they exist at all; everything is a valueless, faceless trade.[14] This somewhat desiccated system in my view breeds outsized risk and runs counter to the fundamentals of a sound financial system where service and the customer should matter a great deal.[15] Regulators and financial firms need to do a better job of evaluating what and how much risk is really passed along with a securitization, and capital charges, concentration and growth limits, and reserving should be applied appropriately.[16] Suitability standards certainly do not disappear and the liability that goes with them - at least in terms of the originator - when paper is securitized.

5. Very serious thought should be given to whether everyone in a securitization or syndication chain should retain some risk in the transaction. Were this to

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[9] Greenspan, Alan. *Bank Supervision in a World Economy.* Speech presented at the International Conference of Banking Supervisors. Stockholm, Sweden. 13 Jun. 1996; Financial Stability Forum (2008), 17-18; and Joint Forum (2008), 25.

[10] Financial Stability Forum (2008), 27-33; and Joint Forum (2008), 17.

[11] Financial Stability Forum (2008), 8-10

[12] Joint Forum (2008), 29.

[13] Financial Stability Forum (2008), 9-10; Joint Forum (2008), 20; and Padoa-Schioppa (1999).

[14] Padoa-Schioppa (1999).

[15] Joint Forum (2008), 11.

[16] Financial Stability Forum (2008), 30; and Joint Forum (2008), 20, 27.

happen, it would dampen the leverage in the system and it would encourage due diligence.

6. Additionally, compensation should be shifted toward giving financial personnel, including importantly traders, a much greater stake in the long-term success of the enterprise.[17] Compensation should be tied to compliant behaviors, including selling customers products that are suitable for the use intended.

7. Un- and under-regulated entities should not be allowed to infect the regulated financial sector. Un- and under-regulated financial entities pose several risks to the financial system. To the extent they are opaque, they make it almost impossible for regulators to assess risk in the financial system - such opacity should not be permitted.[18] The lower standards, including capital standards, of many un- and under-regulated entities gives them a short-term competitive advantage, which allows them to appear more efficient and more profitable and forces the rest of the marketplace to take more risk than would otherwise be the case.[19] We should not permit entities performing the same financial function to exist under two different regulatory regimes. Traditionally, bank supervisors strove to protect banks from the unregulated financial sector by prescribing limits on transactions banks can undertake and by encouraging strong risk management practices. This one-sided approach to financial regulation has failed more than once; it is time to move on. Activities of the under-regulated should be strictly limited or they ought to be properly regulated.[20]

Back to our story: Excess liquidity in the system fueled this business. Spreads narrowed, the yield curve flattened and pricing for risk came under extreme pressure.[21] Investor demand for higher returns created significant interest in structured securities.[22] The securitized tranches were massively leveraged using investment vehicles, such as SIVS and CDOs and CDOs squared.[23]

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[17] Financial Stability Forum (2008), 20.

[18] Financial Stability Forum (2008), 8.

[19] Joint Forum (2008), 26; and Padoa-Schioppa (1999).

[20] Davies, Howard. *Two Cheers for Financial Stability*. William Taylor Memorial Lecture 9 presented at the International Conference of Banking Supervisors in Washington, DC. 25 Sep. 2006, 14. <http://www.group30.org>

[21] Joint Forum (2008), 27.

[22] Joint Forum (2008), 7.

[23] Financial Stability Forum (2008), 5; and Padoa-Schioppa (1999).

Many participants in the large and rapidly-growing marketplace for these instruments were not supervised, such as mortgage brokers, mortgage banks, and hedge funds.[24] And traditional players used SIVs and other vehicles to keep holdings off their balance sheets and lower capital requirements.[25] As a result, the magnitude and interconnectedness of the risk was opaque to market participants, regulators and central banks.[26]

With margins eroding for most financial institutions, pressures to increase volumes stepped up. These pressures were markedly heightened by unrelenting analysts and, in some cases, by large stockholder pressures to grow revenues and profits every quarter. Some senior managements and boards found it difficult to "stop dancing."

Lessons 8, 9, 10, 11 & 12

8. Central banks need to do what they can to control liquidity bubbles and asset bubbles.[27] Society pays serious costs where economic bubbles are allowed to build, including recessions with attendant job losses, property losses, and the long-term losses of no growth or slower growth. Moreover, it is very hard for the supervisor to do its job when economic stimulus pressures are intense.

9. However, where such pressures exist, risks to financial institutions are heightened and regulators must vigorously work to restrain excessive behaviors. In this regard, a special effort should be made to quell analyst and shareholder pressures on bankers to grow revenues and profits on a quarterly or even year-over-year basis, and care should be taken to ensure that conflicts of interest are not disregarded in the pressure to meet profitability hurdles. These short-term profit pressures are typically pernicious and do not take into account risk, certainly long-term risk, which analysts have difficulty in evaluating. Regulators should be a counterweight to this kind of pressure. One way to improve the effectiveness of this counterweight is to tie a much greater portion of executive and board compensation to the long-term results of the bank than is currently the case.[28]

10. Excessive growth in any credit sector virtually always leads to a credit bust. Regulators should quickly identify growth trends and work to restrain such

[24] Financial Stability Forum (2008), 7; and Padoa-Schioppa (1999).

[25] Financial Stability Forum (2008),5.

[26] Financial Stability Forum (2008), 8, 14.

[27] Lee, Hsien Loong. *Post Crisis Asia – The Way Forward.* William Taylor Memorial Lecture 6 presented at the International Conference of Banking Supervisors in Basel, Switzerland. 21 Sep. 2000. <http://www.group30.org>

[28] Financial Stability Forum (2008), 8.

excessive growth and concentration. Rapid growth in a risk or product at a single firm should be a huge red flag for its supervisor.[29] More challenging is to identify rapid growth in a product or sector that is not reflected in any single firm. As the recent environment has shown, significant risks can be embedded in complex instruments and spread across a variety of regulated and unregulated institutions.[30] And the same risks can be spread across one institution in toxic quantity because the risk is parceled out into different corporate pockets without the regulator or company being able to aggregate the risks appropriately. Therefore, regulators globally must work collaboratively to collect, share, and assess risks, to identify concentrations and to take action, and regulators and managements need be able to assess risks across the entire enterprise.[31]

11. The use of leverage throughout the financial system needs to be regulated much more tightly. Excess leverage so magnifies any problem that an exceptional amount of regulatory scrutiny should accompany its use, as well as a bias towards restraint.[32]

12. The use of off-balance sheet vehicles should be much more restrained than it has been.[33] Fundamentally, there should be a bias that strongly favors putting activities on-balance sheet. Off-balance sheet should be essentially limited to completely separate, arms-length enterprises.[34]

I return again to our story. Three assumptions on which this mortgage business was based proved particularly faulty – first, that home prices would go up forever; second, that the consumer, negative savings or not, could borrow his or her way out of a credit hole, in large part because the value of his home was rising; and third, that carefully verified loan documentation did not matter. In short, bedrock rules of safe lending were violated – cash flow coverage, collateral coverage and sound documentation.[35] While the majority of this was originated outside the supervised sector, banks and thrifts were not immune to these violations.

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[29] Financial Stability Forum (2008), 8; and Joint Forum (2008) 10, 28.

[30] Joint Forum (2008), 11.

[31] Davies (2006), 18; and Financial Stability Forum (2008), 41-43.

[32] Financial Stability Forum (2008), 9; and Padoa-Schioppa (1999).

[33] McDonough, William J. *Issues in Corporate Governance.* William Taylor Memorial Lecture 8 presented at the International Conference of Banking Supervisors in Washington, DC. 29 Sep. 2002. <http://www.group30.org>

[34] Joint Forum (2008), 26, 29.

[35] Financial Stability Forum (2008), 7; and Joint Forum (2008), 12.

Inevitably, the poorly written underlying paper began to show delinquency and default characteristics that were unusual for more conservatively written mortgage paper and were outside the range of what the models had predicted.[36] This fact caused greater-than-expected volatility for all tranches of the securitized paper. These negative trends - particularly in a highly-leveraged environment - caused some financial players, notably a few hedge funds and mortgage banks, to fail.[37] The elevated delinquencies, defaults, volatility and failures undermined confidence, including in the ratings process and model-driven structured products. Spreads widened and key markets began to freeze up. Because of the opacity of the marketplace, to which I have referred, and the fact that the initial weaknesses in the marketplace arose from the smaller subprime market, the magnitude of the problem was underestimated.

Mark-to-market accounting accelerated the changes in circumstances emerging from the volatility.[38] Overly-thin reserving - itself a victim of mark-to-market disciplines - and inadequate capitalization at some institutions created some sense of panic. Short sellers emerged in droves, false rumors about troubled institutions spread, which further added to volatility and value deterioration.

Mark-to-market accounting drove asset values down below their future earning power due to the liquidity crisis, and made it more difficult for strategic acquisitions to take place, depriving the markets of sources of capital and stability.

Finally, the widened spreads, market disruptions, and ensuing loss of confidence began to bleed into the general economy.[39] These conditions, plus a further deterioration in credit conditions, gave rise to silent and not-so-silent bank runs, liquidity squeezes and failures or near-failures, leading to the need for more liquidity and capital which in turn has led to a credit contraction.[40] National economies began to sag and infect each other.

By and large in this cycle, regulators have not over-reacted and have been quite mild in their examinations, evaluations and supervisory actions. Central banks, most notably the Federal Reserve, have avoided what could have been an even greater systemic event, by flooding the markets with liquidity, buying paper and taking other extreme measures, which are much heralded in the press.

Lessons 13, 14, 15, 16 & 17

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[36] Financial Stability Forum (2008), 6.

[37] Financial Stability Forum (2008), 32.

[38] Joint Forum (2008), 17.

[39] Financial Stability Forum (2008), 6.

[40] Joint Forum (2008), 12, 14, 26.

13. Weak credit practices inevitably lead to outsized losses.[41] Regulators simply should not permit these practices or should at least ensure that there are serious restraints on, and costs associated with, their use. Regulators and risk officers must continue with even greater vigor to lean against fashion and excess when bubbles are building in good times.

14. Mark-to-market accounting is pro-cyclical and can create excessive volatility. While the objective of loss recognition is an important one, application of mark-to-market accounting is least effective in the midst of a crisis. The recent crisis has demonstrated that asset values can become artificially depressed during a liquidity crisis.[42] Prices in illiquid markets often do not reflect future earning value of assets, but instead reflect the amount of cash available to buyers in the market. Mark-to-market accounting, therefore, can make it harder for a financial entity to work through a crisis, because it portrays a direr picture of a financial entity at an instant in time, than may actually be the case over a longer period of time.

    Mark-to-market accounting needs to be rethought and/or applied quite differently, at least in the financial sector. Whether or not a return to historical cost accounting is called for, the issue deserves serious study and focus.

15. Short sellers increase volatility and exacerbate market downturns. Whether short selling is a free market practice that should be discouraged or not, spreading vicious and false rumors to lower a stock price should be punished.

16. Individual institutions must be required to do a far better job in managing their own liquidity. Too many institutions did not recognize their contingent liquidity obligations, and few performed adequate stress tests to determine an adequate liquidity cushion. The recent guidance by the Basel Committee is a good step toward improving banks' liquidity management practices, but it must be rigorously applied and extend beyond the banking sector.[43]

17. The use of governmental largess, flooding the market with liquidity, bailouts and/or safety net extensions in a time of crisis, is necessary but costly. In addition to the more easily measurable short- and intermediate-term costs, they have serious long-term costs, including the build up of moral hazard. I fear what we have done in this past cycle is to privatize the profits and to socialize the risks. This then sets the framework for less risk-averse behaviors in the future.

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[41] Financial Stability Forum (2008), 36.

[42] Financial Services Forum (2008), 27; and Joint Forum (2008), 25.

[43] Financial Services Forum (2008), 10, 18.

Other lessons learned will emerge as the crisis is studied further. However, one thing should be clear from the lessons that I have just enumerated and from the magnitude of the crisis itself. Tinkering around the edges will not do. It is natural for bank supervisors to respond to financial crises by increasing restraints on banks to protect them from getting infected by the free-for-all going on around them. However, this has the effect of making banking less competitive and more vulnerable to the next crisis. It also tends to push the more risky behavior out to the unregulated sector, where it can grow more rapidly, inviting another debacle.

It is time to step back and think about important changes in our supervisory architecture. That this would be the case is certainly supported by the enormous changes that are taking place in finance itself, brought about by globalization and technological innovation.

Our Regulatory Architecture

There is no clear regulatory architecture that has proven itself so superior that one can with certainty advocate for its adoption. Whether the regulator should be part of the central bank or independent; whether there should be regulatory choice based on charter or geography; and/or whether the regulator should deal with one or all of the issues of market conduct, prudential behavior or systemic events is more a matter of ideological conviction, cultural preference and judgment than demonstrable superiority. However, history, logic and the lessons learned from the current financial turmoil suggest the following principles as the bedrock of the regulatory architecture of the future:

1. *Universal Application of Similar Rules.* First, all institutions that perform the same economic function within a marketplace, irrespective of charter choice or name, should be regulated in an equivalent manner. Whether an entity is called a fund, thrift, a national bank, a state bank, or a Jersey Island, English, French, or Latvian bank, fundamental rules of prudential behavior and market conduct should apply and should be applied for the same sized entity, roughly the same way within that marketplace.

   Admittedly this is a tall order to accomplish. Certainly, rules of disclosure and market conduct can be extended relatively easily to all market players. Prudential rules are another matter. Just look at the years of legitimate effort required simply to harmonize capital requirements - one of many types of prudential rules - for banks - one of many types of financial firms. However, we simply have no choice but to move toward this goal. To do otherwise creates imbalances that threaten the safety and soundness of the marketplace as a whole, and will surely lead to future financial crises. As we are seeing in our current financial crisis, the markets tie entities together so tightly through, for example, structured products, derivatives and securitizations, that risks created by less regulated entities are not self-contained, but end up infecting the entire financial system.

2. *Increased Transparency to Regulators.* Second, the regulatory mechanism should have as complete information as possible about all the financial institutions operating within the regulator's marketplace, and about the marketplace itself.[44] No financial institution or provider of financial services should be immune from supplying this information. Admittedly, the Joint Forum on Financial Conglomerates and its associated committees have done good work to address this through the principle of comprehensive consolidated supervision, but we need to be absolutely sure this principle works in an open and seamless way, and that it applies to all financial services providers.

   Just as regulators need to see a whole institution, they also need to see products and risks across entire markets, whether or not those markets stop at a regulator's border.[45] Mechanisms must be established to collect information on similar products and risks across different institutions and markets.

   And just as importantly, supervisors will need to be prepared to use this information.[46] Supervisors and banks alike focus on what the historical data reveals and indeed have built sophisticated models based on that data. What can get ignored are the new, unexpected events - the tail events - that affect firms and markets in a huge way. One way to address this, as I've noted elsewhere, is through ample liquidity and capital cushions. But too often, information indicating that a tail event is on the way is not seen until after the fact. Supervisors need to acquire, monitor and react quickly to timely, comprehensive risk information.

3. *Regulatory Consolidation.* Third, less is more. We have to reduce the number of international and national organizations setting and applying rules. For the sake of the consistency and efficiency of the regulated sector, the fewer number of bodies setting and/or enforcing the fewer number of rules, the better. This ultimately translates into economic wellbeing, and also reduces the political friction that impedes information sharing and the convergence of regulatory approaches. Now, I realize that neither complete harmonization, nor complete consolidation, of regulation and supervision will be possible. However, we have come a long way towards international regulatory convergence and this must continue. In my country, where we have a cacophony of regulatory bodies, serious regulatory consolidation must take place. Whether or not there should be a single consolidated regulator in the U.S. or elsewhere is an open question. Some places, notably

[44] Crockett (1998); and Financial Stability Forum (2008), 8, 30.

[45] Joint Forum (2008), 17; and McDonough (2002).

[46] Financial Stability Forum (2008), 11.

the U.K. and Japan, have of course already taken this step. Having one regulator makes a great deal of sense from the standpoints of equivalency and efficiency, but large bureaucracies come with their own challenges.

Another knotty problem is the application of home and host country rules to multinational enterprises. International harmonization of rules will eventually solve this problem–but eventually is a long time, and in the meantime multinational enterprises are bedeviled by having to apply a multiplicity of rules to their operations. Minimizing this regulatory burden without degrading supervision is both a possible and an important goal.[47]

4. *Assurance of Efficacy.* Fourth, we should strive to ensure that our rules and supervisory techniques are indeed efficacious and risk-based. Much more needs to be done at the national and international level to test the efficacy of our rules. Just as we expect banks to back-test their models to see if they performed, we should look back at our rules to see if they were effective. Of course, some rules will be as much a matter of time-tested judgment as measurement. However, we should not take our rules and practices for granted. In a dynamic financial world, change is the one certainty with which we must keep up.

5. *Burden Minimization.* A corollary to this notion is that we should strive to minimize excess burden. Regulations and enforcement mechanisms grow like barnacles on a ship. And it is much easier to put a new one in place than take an old one away. Eventually, too many barnacles affect a ship's speed and performance and can even cause it to sink. As regulators test to determine whether rules really do achieve intended goals, they should be prepared to revise or remove those that do not. Continual efforts should be made to minimize burden as changes in finance will cause new rules to emerge and others to become less necessary.

6. *Counter-cyclicality.* Sixth, our regulatory and supervisory framework should be counter-, not pro-cyclical.[48] Although regulators need to be referees, not coaches, and to call the game as they see it, supervision and regulation can only do so much after the cycle has turned and mistakes have been made. As the former chief national bank examiner in the U.S. is wont to say "once the bullet is in the body" there is only so much you can do. Accordingly, it is enormously important to be at least as tough in good times as bad, and the regulatory framework should reinforce this principle.

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[47] Financial Stability Forum (2008), 52.

[48] Crockett (1998); and Fischer, Stanley. *Basel II: Risk Management and Implications for Banking in Emerging Market Countries.* William Taylor Memorial Lecture 7 presented at the International Conference of Banking Supervisors in Cape Town, South Africa. 19 Sep. 2002. <http://www.group30.org>

7. *Market Conduct and Prudential Supervision.* Seventh, market conduct and prudential supervision go hand in glove. In today's day and age, it is not possible to have a safe and sound banking organization that is a rogue in the marketplace. Nor is it possible to have a stable banking system where customers are cheated, laws are flaunted or conflicts of interest are disregarded. There is no better example of this than the recent auction-rate securities fiasco. The mistreatment of customers exposed the firms involved to significant financial and reputation risk, not unlike that which would result from asset quality problems.

   Whether different organizations or a single regulator with different divisions should be responsible for market conduct and prudential supervision is a decision for national regimes. Either way, the prudential regulator must evaluate market conduct as a potential financial risk, and should expect the institutions it supervises to do so as well.

8. *Implementation.* Eighth, integral to the regulatory architecture that I have just described, is the quality of implementation by the regulatory bodies. This implementation must be accomplished with integrity, judgment and vigor. Perhaps the most important attribute of the regulatory process – and why it must be independent from the political process and any other body that can compromise its mission – is that an effective regulatory function must be thoroughly honest and hands-on in its practical examination of the facts and in its application of the rules.

9. *The Profession of Supervision.* Finally, if we are to have an effective supervisory service in this ever more complex financial world, as well we must, then we need to step back and assure ourselves of several things:

   - Supervisors should be well-prepared for their job.[49] Why is supervision not a university major? One can major in athletics instruction, modern dance and film these days, but when a major bank supervisory agency needs additional examiners, they must train their own. This has worked well in the past, but with the growing challenges, and the need for global consistency of approach, supervision should be elevated to a profession. The Basel Committee had the foresight to establish the Financial Stability Institute in 1999 to assist with training of the non-G10 country supervisors. It is now time to consider establishing a Financial Supervision Chair at a prominent university.

   - Legislators that give supervisors their mandate must make the goals of supervision clear. We are all familiar with the difficult policy trade-

[49] McDonough (2002).

offs inherent in supervision. These need to be wrestled with at the highest levels of government, rather than dealt with on an ad hoc basis.

- Supervisors must make the rules clear and transparent. Supervision works best when regulated institutions know what is expected of them and when they receive a consistent and swift reaction if they do not conform to these expectations.

- Supervision should take advantage of market forces. In this regard, perhaps the most powerful market force of all is compensation. In this regard, I would urge that supervisors, as well as companies, align compensation with safe, sound and compliant behaviors, with a particular emphasis on the long-term wellbeing of the financial concern, as opposed to short-term benefits to the individual.[50]

Conclusion

In conclusion, supervision should remain at the center of a new global financial architecture. Clearly, central banks have a vital role in maintaining financial stability, and will continue to, from time to time, intervene when they consider it necessary to stabilize markets. But a key reason that this is a viable option for central bankers is the presence of a consistent, objective, and reliable supervisory program.

Regulators are all about calling the plays as they see them, whether or not the truth is painful. Good regulators, like good referees, do not seek to be rock stars, nor do they seek to win popularity contests. They strive to meet the high standards set by William Taylor, the namesake of this lecture series, and the truly successful ones do.

Thank you.

[50] Financial Stability Forum (2008), 8.

Statement of the Hon. Jim Rokakis
Treasurer, Cuyahoga County, Ohio
Senate Committee on Banking, Housing, and Urban Affairs
"Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis."
October 16, 2008

Mr. Chairman and members of the committee, thank you for the opportunity to speak before you today. My name is Jim Rokakis and I am the Treasurer of Cuyahoga County, Ohio, the state's largest county, representing Cleveland and 49 cities, villages and townships.

While the events of the past several months have focused the attention of the entire financial world on the practices of the subprime lending industry, we have suffered the consequences of reckless and irresponsible lending for many years. Since the late 1990s, Ohio and Cuyahoga County have consistently led the nation in this sad statistic of foreclosure filings.

Consider these numbers, please. In 1995, 3,345 private mortgage foreclosures were filed in Cuyahoga County and 15,975 were filed statewide. By 2000, over 7,500 private foreclosures were filed in Cuyahoga County and over 35,000 in Ohio – better than double the number of filings five years earlier. In 2006, 13,610 foreclosures were filed in Cuyahoga County and over 79,000 statewide. Over 15,000 were filed in Cuyahoga County in 2007. Sadly, we are on pace to foreclose on an additional 15,000 properties in Cuyahoga County in 2008.

I am accompanied here today by Professor Howard Katz, a professor of law from Elon College who was our Director of Strategic Planning in 2000. Professor Katz and I approached the Federal Reserve Bank of Cleveland in the fall of 2000 to ask for their help in controlling the reckless lending practices that were doing real harm to Cleveland neighborhoods, harm I describe in detail in an article I wrote for the Washington Post entitled "Shadow of Debt." We knew the Fed had the authority to act under the Home Ownership Equity Protection Act and under the truth in lending laws. Our hope was that the Fed would step up once they knew the extent of the problem. That was our hope. The Fed cosponsored a one day conference in March of 2001 entitled "Predatory Lending in Ohio" where we discussed potential solutions, federal and local. Our keynote speaker was Fed Governor Ed Gramlich, who passed away in 2007. The late Governor Gramlich understood the nature of this problem and as we all know, warned Fed Chairman Greenspan about the need to regulate these practices. Nothing of substance came from this conference. In frustration, local ordinances were passed later that year in Cleveland, Dayton and Toledo to try to slow the real estate industry down. Within 90 days the Ohio legislature passed a law preempting the right of Ohio cities to regulate in this area.

In early 2005, I approached U.S. Attorney Greg White and requested a meeting of federal and local officials to deal with these practices from the enforcement side as we knew that we were the victims of fraud on an industrial scale. This meeting included U.S. Attorney White, other Assistant U.S. Attorneys, FBI agents and postal inspectors where we begged that federal authorities make this a high priority.

I still remember on Assistant U.S. Attorney making the point that they had received not a single complaint from any of the mortgage banks involved in these loans. He asked me, "If they aren't complaining, who are the victims?" The answer to that question is obvious, Mr. Chairman, the victims? How about the whole world. This wasn't people robbing banks, Mr. Chairman – this was banks robbing people.

For the record, a negligible amount of prosecutions came as a result of this meeting. The only significant prosecutions have been by our county prosecutor's office.

Mr. Chairman, I would like to use remaining time to discuss the attempts to pin the crisis on the Community Reinvestment Act of 1977. You all know what the CRA is, what it does, and what it doesn't do.

Mr. Chairman, if you want to understand how silly this allegation is, you just need to look at the lending data for the City of Cleveland.

The peak year for home purchase mortgage origination in Cleveland was 2005. A local non-profit research organization, the Housing Research and Advocacy Center, has analyzed the Home Mortgage Disclosure Act data for that year. They found that of the top ten mortgage originators in the city that year, only four were affiliated in any way with local depository banks, and those four accounted for less than 15% of the total mortgages originated.

Of the 7,128 Cleveland mortgages reported in HMDA data that year, 1,248 – almost 18% - were originated by the now-defunct subprime lender Argent Mortgage Company. Argent was never covered by the CRA.

The second biggest Cleveland lender that year was New Century Mortgage, also now defunct, with 375 home purchase origination, a little more than 5% of the total. New Century was never covered by the CRA.

The third biggest lender, also accounting for about 5%, was Third Federal Savings, which is a local bank covered by the CRA. Third Federal is famous in Cleveland for being one of the few really good guys in Cuyahoga County's horrible subprime foreclosure story.

Numbers 4, 5, and 6 on Cleveland's 2005 Top Ten Lenders list, each with between 4 and 5% of the originations, were Aegis Funding, Countrywide, and Long Beach Mortgage, which as you know is a subsidiary of Washington Mutual. The only institution with any CRA obligations on this list is WaMu, and Cleveland is a long, long way from WaMu's depository service area.

Finally, way down the top ten list, we get to Charter One Bank's mortgage subsidiary CCO mortgage, National City's mortgage subsidiary National City of Indiana, and Fifth Third Mortgage...each with about 3% of the market, adding up to just 648 loans. Did they make these loans to help their parent institutions' CRA ratings look better? Possibly. Did these 648 loans play a major role in the city's default and foreclosure crisis? Hardly.

The same housing center study also lists the top ten originators of home refinance mortgages, of which there were almost as many in 2005 as home purchase loans. Argent Mortgage also dominates this list with 17% of the total. Only two local depositories even appear on it – Third Federal and JP Morgan Chase. Third Federal, as I pointed out earlier, was one of the few non-predatory, non-subprime, locally serviced, low-foreclosure lenders doing a lot of business in the city during this period.

In any event, these two banks combined total of HMDA-reported refinancing mortgages in Cleveland in 2005 was 505 out of almost 7,000 – a whopping 7%.

Mr. Chairman, the foreclosure crisis in Cleveland for the last six years has not been driven by our CRA-covered depository banks, even though some of them – notably National City – were minor players. The problem has been driven by Argent, New Century, Aegis, Countrywide, Long Beach, Wells Fargo, and dozens of other subprime and high-cost loan peddlers with no local depository services and no Community Reinvestment Act obligations in our community.

Thank you for this opportunity. I will answer any questions you might have.

The Washington Post

The Shadow of Debt

Slavic Village Is Fast Becoming a Ghost Town. It's Not Alone.

By Jim Rokakis
Sunday, September 30, 2007; B01

CLEVELAND - Let me tell you about a place called Slavic Village and the death of a girl named Cookie Thomas. You've never heard this story before -- talk of housing markets and hedge funds, interest rates and the Federal Reserve has drowned it out.

Twenty years ago, the Slavic Village neighborhood of Cleveland was a tightly knit community of first- and second-generation Polish and Czech immigrants. Today, it's in danger of becoming a ghost town, largely because a swarm of speculators, real estate agents, mortgage brokers and lenders saw an opportunity to make a buck there.

You could say it was because of them that 12-year-old Asteve' "Cookie" Thomas lost her life on Sept. 1, shot in Slavic Village when she stumbled into the crossfire of suspected drug dealers. The neighborhood wasn't always a haven for criminals -- not until hundreds of foreclosures destabilized the community. Houses (800 at last count) and then entire streets were abandoned. Crime increased as vacant properties offered shelter to people who had a reason to hide.

Another victim was Joe Krasucki. On the night of March 15, his 78th birthday, he thought he heard vandals prying the aluminum siding off his house, where he had lived for 40 years. Looters had already ransacked his neighbor's abandoned property -- a fate that awaits the majority of foreclosed houses in cities such as Cleveland. When Joe went outside to investigate, a gang of teenagers beat him so severely that he died a week and a half later.

Cookie Thomas and Joe Krasucki haunt me because they didn't have to die. In a sense, their deaths were foreshadowed in the late 1990s, when the dark side of the real estate industry -- the predatory lenders -- came to Ohio, including Cleveland's Cuyahoga County, where I serve as treasurer. They knew that the state's lax regulatory structure would give them virtually free rein. This is when we first heard terms such as "securitization," "mortgage-backed securities," "3-28s" and "risk modeling." These are code words for Wall Street strategies that made the cycle of no-money-down, no-questions-asked lending possible -- the strategies that have sucked the life out of my city.

Cleveland isn't alone. In Stockton, Calif., lenders filed for foreclosure on one in 27 households in the first half of 2007, according to RealtyTrac.com, a marketer of foreclosed properties. The Detroit area watched as foreclosure proceedings started on one in 29 households. One in 122 households in the metropolitan area of Bridgeport, Conn., had a foreclosure filing, an increase of 552 percent from 2006.

The national outlook isn't good, either. RealtyTrac.com reports that there could be more than 2 million foreclosures in 2007. Home builders haven't struggled so much since the 1991 recession.

Last month, the sale of new homes fell to its lowest rate in more than seven years. And the Federal Reserve's Sept. 18 decision to cut interest rates by half a percentage point tells you that we're all in trouble: homeowners, who stand to lose their biggest investment; lenders, who are going bust at a record rate; citizens, who return home each night to dangerous neighborhoods; and city governments, which simply don't have the resources to solve their communities' problems.

Funny thing, the mortgage business. For years, buyers, sellers and lenders operated under the arcane notion that if you wanted to own a home, you needed a down payment and some semblance of a good credit history. Along with other consumer advocates and community leaders, I once battled the evils of redlining, a practice that denied loans to people -- largely minorities -- who lived in neighborhoods that banks considered too risky for investments. At that time, we fought for fair but sensible lending.

That's why we couldn't comprehend the new rules that predatory lenders brought to town. They offered "creative" loans to people with weak credit and, later, to others with no credit history at all. The practice defied logic. It was as if Wall Street brokers came to places such as Slavic Village and said, "Okay, you want money? We'll give you money. We'll give you more money than you dreamed possible."

They did, and predictably, the loans went bad. Borrowers managed to pay the deceptively low initial payments but fell into foreclosure when the monthly payments ballooned -- a hallmark of the predatory loan. The sad truth is that for many of these buyers, responsible home ownership was simply out of their economic reach.

In June, the Mortgage Bankers Association blamed the nation's high foreclosure rate in part on the hemorrhaging of manufacturing jobs in Ohio, Michigan and Indiana. This shouldn't have come as news to anyone; the whole country realized the scope of those losses years ago. So I'd like to ask mortgage bankers why they continued making loans to people who would never be able to pay them off. Foreclosures in my own Cuyahoga County doubled from 3,500 in 1995 to more than 7,000 in 2000, and houses all over Cleveland began emptying out -- houses like the one next door to Joe Krasucki.

Don't think we didn't try to halt the trend. In 2001 and 2002, the city councils of Dayton, Cleveland and Toledo all passed anti-predatory lending laws. (In 2002, there were 8,987 private mortgage foreclosures in Cuyahoga County alone, the worst of any county in the country.) But lobbyists for the real estate industry would have none of it. In February 2002, an army assembled in Columbus, the state capital, to overturn the cities' efforts -- dozens of lobbyists representing mainstream banks, mortgage banks, brokers, real estate agents, title companies, appraisers and Wall Street firms. They overwhelmed consumer advocates, and the Ohio legislature passed a bill preempting the right of municipalities to enact predatory lending legislation.

Lawmakers promised to address the problem that the city ordinances had sought to correct, but they sat tight for four years. The tsunami of foreclosures forced the legislature's hand in 2006, when lawmakers passed a bill that reined in brokers and appraisers. But by then, the crisis had engulfed Ohio's cities and even its suburbs. More than 13,600 private mortgage foreclosures were filed in Cuyahoga County in 2006 -- again, the worst in the nation.

The Federal Reserve's recent decision to cut interest rates may calm the nerves of Wall Street bankers, but it won't bring back Cookie Thomas or Joe Krasucki. Nor will it help the thousands of innocent people in Cleveland who live on streets with vacant houses. These hard-working citizens have watched their single most valuable asset, their home, plummet in value. According to a study by Dan Immergluck at the Georgia Institute of Technology, living within 150 feet of a vacant house reduces your property value by at least $7,000. But for too many people, that disconcerting news is beside the point: Even if they wanted to sell their homes, they wouldn't be able to find buyers. Who wants to live in a sea of foreclosures where drug dealers roam the streets and vandals covet the aluminum siding on your house?

In my county, more than 74,000 homeowners have filed for property tax reductions this year -- people like the elderly woman on Berry Avenue on Cleveland's west side who brought me a beautiful photo montage of her well-maintained home, sitting in the midst of abandoned houses. She sobbed quietly as she explained that she had spent thousands of dollars on upkeep and on improving the property. That's money she will never get back. We've all read about the losses at investment-banking firms like Bear Stearns, but we don't read about that woman on Berry Avenue.

The interest-rate cut won't help city governments, either. It does nothing for the 10,000 vacant structures in Cleveland, almost all of them abandoned since the late 1990s. Nor will it cover the $100 million demolition bill facing this city. You see, most of these vacant structures will never be restored; all you can do is pull them down. They've been stripped of anything of value -- copper piping, furnaces, windows, doors, you name it. Cleveland City Councilman Michael Polensek recently described to me the scavengers' efficiency: They arrive at a house less than a day after it has been vacated and strip it clean within hours.

A flurry of legislative proposals has come before Congress, including bills by Rep. Keith Ellison (D-Minn.) and Sens. Charles E. Schumer (D-N.Y.), Robert P. Casey Jr. (D-Pa.) and Sherrod Brown (D-Ohio). These bills prohibit brokers from steering home buyers into higher-priced loans and require borrowers to prove that they can make their monthly payments, not only at the low teaser rate but also at the higher rate that follows. Helpful steps, but too late.

Unfortunately, none of these bills addresses the costs to cities associated with maintaining, policing and, in the most dire case, demolishing neighborhoods such as Slavic Village. One bill introduced in Congress would allocate $100 million over the next three years to help with demolition costs -- a number that met with peals of laughter at a conference on vacant properties that I attended in Pittsburgh last week. "Add a zero," one participant suggested.

Cities aren't asking for a bailout; they're asking for emergency funds to address the huge costs they've incurred because a private-sector industry was out of control. Congress needs to help the cities that helped make this country great -- cities like Detroit and Cleveland. And they need to do it for Cookie Thomas and Joe Krasucki.

Jim Rokakis is treasurer of Cuyahoga County, Ohio.

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The Federal Reserve Board

Remarks by Governor Edward M. Gramlich

At Cleveland State University, Cleveland, Ohio
March 23, 2001

Governor Gramlich presented identical remarks at the Neighborhood Reinvestment Corporation luncheon, Raleigh, North Carolina, March 26, 2001

Tackling Predatory Lending: Regulation and Education

I am pleased to participate in today's conference on predatory lending. This seems to have become a major problem around the country, as in Ohio. Conferences such as this provide a valuable opportunity to learn more about this very complex topic. One of the welcome developments in recent years is the expansion of the home mortgage market to a broader socioeconomic range of borrowers. Studies of urban metropolitan data submitted under the Home Mortgage Disclosure Act (HMDA) have shown that lower-income and minority consumers, who have traditionally had difficulty in getting mortgage credit, have been taking out loans at record levels in recent years. Specifically, conventional home-purchase mortgage lending to low-income borrowers nearly doubled between 1993 and 1999, whereas that to upper-income borrowers rose 56 percent. Also over the same period, conventional mortgage lending increased by about 120 percent to African-American and Hispanic borrowers, compared with an increase of 48 percent to white borrowers.

Much of this increased lending can be attributed to the development of the subprime mortgage market. Again using HMDA data, the number of subprime home equity loans has grown from 66,000 in 1993 to 856,000 in 1999, a thirteen-fold increase. Over this same period, the number of subprime loans to purchase homes increased sixteen-fold, from 16,000 to 263,000. This rapid growth has given credit access to consumers who have difficulty in meeting the underwriting criteria of prime lenders because of blemished credit histories or other aspects of their profiles. This expansion of credit gives people from all walks of life a shot at the twin American dreams of owning a home and building wealth.

But along with these positive developments have come disquieting reports of abusive lending practices, targeted particularly at female, elderly, and minority borrowers. These practices, many of which can result in consumers' losing much of their equity in their home, or even the home itself, are commonly referred to as "predatory lending." Predatory lending can damage these same hardworking but low-income people and the communities in which they live. Its growth is a noticeable blight in this otherwise attractive mortgage-lending picture.

The term "predatory lending," much like the terms "safety and soundness" and "unfair and deceptive practices," is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. But typically predatory lending involves at least one, and perhaps all three, of the following elements:

- making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation ("asset-based lending")
- inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping")
- engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Some of these practices are clearly illegal and can be combated with legal enforcement measures. But some are more subtle, involving the misuse of practices that most of the time can improve credit market efficiency. For example, the freedom for loan rates to rise above former usury law ceilings is generally desirable in that it matches relatively risky borrowers with appropriate lenders. But sometimes the payments implicit in very high interest rates can spell financial ruin for borrowers. Most of the time, balloon payments make it possible for young homeowners to buy their first house and match payments with their rising income stream. But sometimes balloon payments can ruin borrowers who do not have a rising income stream or who are unduly influenced by an immediate need for money. Most of the time, the ability to refinance mortgages permits borrowers to take advantage of lower mortgage rates, but sometimes easy refinancing invites loan flipping, resulting in high loan fees and unnecessary credit costs. Often credit life insurance is desirable, but sometimes the insurance is unnecessary, and at times borrowers pay hefty up-front premiums as their loans are flipped. Generally advertising enhances information, but sometimes it is deceptive. Most of the time, disclosure of mortgage terms is desirable, but sometimes disclosures are misleading, with key points hidden in the fine print.

Predatory lending entails either fraud or the misuse of these and other complex mortgage provisions that are generally desirable and advantageous to a borrower, but only when the borrower fully understands them.

Home Ownership Equity Protection Act (HOEPA)

The Congress has passed a number of consumer protection statutes in this area. One important law is the Home Ownership and Equity Protection Act (HOEPA) of 1994, an amendment to the earlier Truth in Lending Act. Among other things, HOEPA requires that the Federal Reserve Board periodically conduct public hearings to gather information about trends within the home equity market. This summer the Board held a second round of HOEPA hearings in Charlotte, Boston, Chicago, and San Francisco. Earlier hearings had been held in 1997 and had led to a joint report to the Congress from the Board and HUD.

The basic approach of HOEPA is to shine a bright spotlight on high-cost mortgage loans. For these high-cost loans, certain practices--balloon payments in the first five years, prepayment penalties, and a pattern and practice of asset-based lending--are banned. In addition, for HOEPA-covered loans, creditors must provide a short disclosure to borrowers three days before the loan is closed; loans under HOEPA are also subject to the normal three-day rescission period that pertains to other home equity loans. This gives many HOEPA borrowers twice as long to change their minds about possibly unwise mortgage contracts. HOEPA is not a usury law--high-cost loans can still be made--but borrowers' protections are significantly greater for HOEPA loans than for other subprime mortgage loans.

Last December 13 the Board solicited comments on proposed revisions to our Regulation Z, the regulation implementing HOEPA. The goal of the changes was to curb some abuses we were made aware of during our hearings and through other sources. At the same time, we tried to make our amendments narrow and selective so as not to impede the general growth of the legitimate subprime mortgage market. The important changes involved broadening the scope of mortgage loans subject to HOEPA coverage and prohibiting specific acts and practices.

With respect to loans subject to HOEPA, the law lays out a two-part test for coverage. The first involves interest rates. If the annual percentage rate (APR) on a mortgage loan exceeds the Treasury rate on a bond of comparable maturity by more than 10 percentage points, the loan is subject to HOEPA protections. The Board has the legal authority to lower this threshold to 8 percentage points, and the proposal recommends doing that. Data on this segment of the mortgage market are sparse, but a special survey by the Office of Thrift Supervision (OTS) estimates that the portion of subprime mortgage loans falling within the HOEPA's APR trigger is currently about 1 percent, with this segment of the market rising to about 5 percent under the proposal. From this standpoint, the effect of this change on the general growth in subprime mortgage lending should be modest.

But these percentages are based on rates alone, and many subprime lenders feel that the coverage percentages are higher when the second HOEPA test enters in. Under this second test, loans with non-interest fees of more than 8 percent of the loan amount, or $465, are covered by HOEPA. Although the Board cannot change these amounts, it can alter the items included in this points and fees test.

The proposal recommends adding premiums on single-premium credit insurance to the points and fees test. Premiums for this insurance are generally financed in the loan amount, the insurance is often unnecessary, and premiums may be difficult to recover if the loan is cancelled. When loans are flipped, financed single-premiums for credit insurance can be a way to strip equity from a homeowner. We do not know how many additional mortgage loans this change would bring under HOEPA, but it is likely to greatly constrict the selling of single-premium credit insurance. Under the proposal, the provisions regarding other ways of selling credit insurance would not change, and these alternative ways of selling credit insurance would thereby be encouraged.

These changes would extend the coverage of HOEPA and its consumer protection provisions. Presumably, the number of subprime foreclosures would be lessened. But because HOEPA loans are already more costly to make and they carry a stigma in the secondary market, these changes may also constrict lending in the very high cost segment of the subprime market. Many consumer advocates have said that they are aware of this possible tradeoff and accept it. Now that the proposed revisions to the regulation are out for public comment, we will be able to examine the responses in more detail.

The Board proposal also prohibits a number of specific acts and practices. There are two provisions to reduce loan flipping. The proposal would prohibit a creditor that holds a HOEPA loan from refinancing the original credit with another high-cost loan within twelve months of origination. The proposal would also prohibit creditors from refinancing with higher-rate loans certain zero-interest loans or other very low cost loans originated through mortgage assistance programs. Both provisions have an escape clause that permits these refinancings if the creditor can show that the loan is in the borrower's interest, a provision likely to come into play in foreclosures or other legal proceedings in connection with the loan. Together these provisions should reduce the most egregious instances of loan flipping-

-where creditors either flip loans immediately on origination or refinance very low interest loans at much higher rates.

The proposal also tries to stem the practice of making loans that are not based on the borrower's ability to repay an obligation, so-called asset-based lending. The proposal would require that lenders document and verify consumers' ability to repay HOEPA loans. Because a pattern or practice of making asset-based HOEPA loans is already prohibited, legitimate subprime lenders presumably already have procedures to show that they are not engaged in a pattern or practice of making asset-based loans. Consequently, this provision should not affect effect legitimate subprime lenders, though it should deter predatory lenders, who will have difficulty proving the legitimacy of their asset-based credit decisions.

These recommendations often reflect hard tradeoffs with potentially significant effects on creditors and consumers alike. The Board will have to undertake a difficult balancing effort when it adopts a final rule. It will be essential that we receive thoughtful comments from all segments of the public and from the industry to help us make an informed final decision.

Home Mortgage Disclosure Act

About the same time, last November 29, the Board also solicited comments on proposed revisions to our Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). HMDA requires depository and certain for-profit nondepository institutions to collect, report, and disclose data about applications for, originations of, and purchases of home-mortgage and home-improvement loans. From these data denial rates can be inferred. Data now reported include the type, purpose, and amount of the loan; the race or national origin, gender, and income of the loan applicant; and the location of the property. The purposes of these HMDA reports include helping us to determine whether financial institutions are serving the housing needs of their communities and to enforce fair lending.

The Board's proposal incorporates suggestions received in response to an earlier Advance Notice of Proposed Rulemaking, as well as from discussions with a wide range of interested parties. In evaluating potential changes, the Board considered whether the changes would improve the quality and utility of the resulting data to enhance understanding of the home mortgage market. At the same time, the Board attempted to minimize the increase in data-collection costs and reporting burden by limiting proposed changes to those likely to have significant benefits. As we have done in the past, we will make available software to help reduce the reporting burden for financial institutions.

The three fundamental changes in the proposal would

- increase the number of nondepository lenders required to submit data
- clarify and expand the types of reportable transactions
- specify new loan elements to be included in the data.

First, with respect to the coverage of nondepository lenders, the Board's proposal would alter definitions to require all nondepository lenders whose annual home purchase and refinancing activity comprises at least 10 percent of the dollar value of all their loan originations (mortgage- and nonmortgage-related), or $50 million, to report HMDA data. The new element is the $50 million reporting floor, which extends HMDA coverage to very large nonbank lenders with relatively small percentages of mortgage loans in their portfolios. Because the added coverage affects very large mortgage lenders, it seems consistent with any reasonable test of determining whether a lender is "engaged in the business of mortgage lending," the statute's test for coverage.

Second, the expansion of the types of transactions covered is intended to improve the integrity of the data by establishing consistency in reporting requirements. Right now, data on refinancings and home improvement loans are unclear, and quite likely incomplete, because the regulation provides lenders with much flexibility in determining which loans to report. For example, lenders may avoid reporting closed-end home improvement loans by not classifying them as such in their records. Lenders also may choose not to report open-end home equity lines of credit, even if used for home improvement. The proposal would tighten these definitions so that the resulting data would be more complete and more consistent from one lender to the next. This change, too, certainly seems consistent with the spirit of HMDA.

Third, the proposal specifies that three new items be reported from a consumer loan or application: the APR, whether the loan is subject to HOEPA, and whether the loan involves a manufactured home. Having APR and HOEPA information will assist in the identification of subprime loans, enabling better analysis of the high-cost subprime market. We will be able, among other things, to ascertain with much more precision the extent of present HOEPA coverage and the way that coverage might change were the Board to extend its HOEPA coverage, as discussed above.

The collection of data on mobile or manufactured home loans will contribute to an improved understanding of this type of lending, which employs different underwriting criteria from those for loans secured by conventional homes. Because manufactured home loans have much higher denial rates than other mortgage loans, such data would also enhance understanding of denial patterns in this market.

Again, the Board tried to balance competing interests in fashioning this proposal. As with HOEPA, it will be critical that the Board receives thoughtful public comment on the proposal to assist it in making its final rule on this regulation.

Other steps may need to be taken, and may be taken, to deal with predatory lending. But these proposals should represent important first steps. The HOEPA changes extend the coverage and protections of HOEPA and limit some current practices that may end in abuse. The HMDA changes should greatly improve our information about lending practices for high-cost mortgages. Both proposals may limit abusive practices in the short-run and should greatly improve our knowledge and enforcement ability in the long-run. At the same time, the HOEPA proposal is designed to interfere minimally with the vast bulk of subprime lending, and the HMDA proposal is designed to gather useful data while limiting reporting burden.

Consumer Education

Going beyond these regulatory and data-collection measures, we should all recognize that in the long-run the very best defense against predatory lending is probably in neither of these approaches. Rather, it is in a thorough knowledge on the part of consumers of their credit options and resources. Educated borrowers who understand their rights under lending contracts and who know how to exercise those rights put up the best defense against predatory lenders. As the knowledge base of consumers grows, the market for credit-at-any-cost diminishes.

Unfortunately, as is often the case, the best long-run solutions can be the most difficult to implement. A massive educational campaign is needed to bring about this expanded consumer knowledge, particularly within the socioeconomic groups most likely affected by predatory lending. Many efforts are under way. As one example, the Neighborhood Reinvestment Corporation, a publicly funded entity that is known for its community training and homebuyer counseling programs, has embarked on a huge low-income-homeowner education project. As another, the American Bankers Association has formed a working group to educate bankers and local communities about predatory lending.

We in the Federal Reserve System are also trying to do our part. We have undertaken many projects designed to promote community and consumer education and financial literacy. Board staff have been active in an interagency task force convened to identify strategies for combating predatory lending. This group is also looking for ways to support the broad array of organizations that offer consumer and community education to complement homeowner education efforts. We have also been active in planning conferences on the topic, similar to today's conference.

Further, nearly every one of the twelve Reserve Banks has published articles devoted to predatory lending in its Community Affairs newsletters. In aggregate, these reach tens of thousands of community development and housing organizations nationwide. The Federal Reserve Banks of Atlanta, Philadelphia, and right here in Cleveland have sponsored seminars to educate community leaders and lenders on the differences between legitimate subprime lending and predatory lending. These meetings have also provided a forum for groups assisting victims to report the most egregious practices of unscrupulous lenders and the devastating impact of these loans on their clients. Federal Reserve Bank of Boston staff members have worked closely with a secondary market purchaser to promote an educational campaign through local community groups. Chicago Reserve Bank officials have facilitated a task force of area advocacy groups, lenders, and real estate industry representatives to help develop recommendations for combating predatory lending. The Chicago Fed has also launched "Project Money Smart," a resource on its web site that provides a comprehensive overview of consumer information on personal finance topics, including managing credit, understanding mortgages, and protection against fraud. And the Dallas Fed has published "Building Wealth," a manual designed to help individuals and families develop a plan for building personal wealth. This Bank's web site offers an interactive tool for customizing wealth-building strategies by setting financial goals, seeking guidance, budgeting, saving and investing, and managing debt.

These are a few examples of ways in which the Federal Reserve is trying to improve financial literacy in all segments of the population. The educational challenge is difficult, but these initiatives and other collaborative education efforts can greatly improve financial market efficiency. In the long run, they provide the best defense against predatory lending.

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Predatory Lending in Ohio:

Searching for Solutions

A one-day conference examining the problem of predatory lending in Ohio and developing legislative and other solutions.

Sponsored by the Levin College of Urban Affairs, Cleveland-Marshall College of Law, Cuyahoga County Treasurer James Rokakis, and the Federal Reserve Bank of Cleveland.

Friday
March 23, 2001
Cleveland State University

Predatory Lending in Ohio
The Urban Center
1717 Euclid Avenue
Cleveland, Ohio 44115

| AGENDA&uSPEAKERS'l

, Frid;;' March 23," 2 o Oil

Please note: speakers and session times may change.

8:00-8:45 AM
Registration and continental breakfast

8:45-9:00
Welcome
James Rokakis, Cuyahoga County Treasurer
Mark Rosentraub, Ph.D.
Dean, Levin College of Urban Affairs

9:00-10:00
What's the Problem?
A Predatory Lending Education Piece
Jacqueline King, Federal Reserve Bank
Chip Bromley, Metro Strategy Group
Pat McCoy, Cleveland-Marshall College of Law

10:00-10:15
Break

10:15-11:30
Best Practices in Other States:
Legislation, Regulation, & Local Ordinances
Moderator: Kathleen Engel, Cleveland-Marshall College of Law
State Level:
Sabrina Comizzoli, NY Attorney General's Office
Stella Adams, N. Carolina Fair Housing Center

County Level:
Thomas FitzGibbon, Chicago Manufacturers Bank
Pastor Herrera Jr., LA County Dept. of Consumer Affairs

11:45-1:15
Lunch and Keynote
Edward Gramlich, Governor, Federal Reserve Bank
Introduction, Stephen Ong, Federal Reserve Bank

1:15-2:30
Legislative Options in Ohio
Moderator: Patricia McCoy, Cleveland-Marshall College of Law
Bill Faith, Coalition on Homelessness & Housing in Ohio Rachel Robinson, Ohio State Legal Services Association Timothy Grendell, Ohio House of Representatives
Banking industry representative (not confirmed)

2:30-2:45
Break

2:45-4:00
Best Practices in Litigation and Community Education
Moderator: Dennis Keating, Levin College of Urban Affairs
Litigation:
Diane Citrino, Housing Advocates, Inc. Steve Olden, Legal Aid Society of Cincinnati Anita Lopez, Toledo Fair Housing Center

Moderator: Kent Smith, Euclid Community Concerns
Community Education:
Andre Reynolds, Neighborhood Housing Services
Lisa Gold Scott, City of Cleveland

This course has been approved by the Ohio Supreme Court Commission on Continuing Legal Education for 4.75 CLE credit hours, including 0 hours in ethics, 0 hours in substance abuse, and 0 hours in professionalism instruction.

Plenary sessions and registration will be held in the Moot Court Room,
Cleveland-Marshall College of Law
1801 Euclid Avenue

Lunch and keynote will be held in the Atrium of the Levin College of Urban Affairs
1717 Euclid Avenue

on the campus of
Cleveland State University

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Predatory Lending in Ohio: Searching for Solutions

Conference Agenda

Registration and plenary sessions will be held in the Moot Court Room of the Cleveland-Marshall College of Law. Lunch and keynote will be held in the Atrium of the Maxine Goodman Levin College of Urban Affairs.

8:00-8:45 **Registration and continental breakfast**

8:45-9:00 **Welcome**

James Rokakis, Cuyahoga County Treasurer

Ste_ven H. Steinglass, Dean, Cleveland Marshall College of Law

Mark Rosentraub, Ph.D., Dean, Maxine Goodman Levin College of Urban Affairs-

9:00-10:00 **What's the Problem? A Predatory Lending Education Piece**

Jacqueline King, Federal Reserve Bank,-"Definitions"

Chip Bromley, Metro Strategy Group, "The Scope of the Problem"

Kathleen Engel, Cleveland-Marshall College of Law, "The Need for Legislation"

10:00-10:15 **Break**

10:15-11:30 **Best Practices in Other States:** Legislatio~1 **Regulation, & Local Ordinances**

Moderator: Kathleen Engel, Cleveland-Marshall College of Law

State Level Panel:

Sabrina Comizzoli, NY Attorney General's Office

Stella Adams, Executive Director, North Carolina Fair Housing Center

County Level Panel:

Thomas FitzGibbon, Chicago Manufacturers Bank

Pastor Herrera, Jr., Los Angeles County Department of Consumer Affairs

11:30-1:00 **Lunch and Keynote**

Edward Gramlich, Governor, Federal Reserve Bank

Introduction by Stephen Ong, Federal Reserve Bank

1:15-2:30 **What Can Be Done in Ohio?**

Moderator: Patricia McCoy, Cleveland-Marshall College of Law Panel

Bill Faith, Coalition on Homelessness & Housing in Ohio (COHHIO) Rachel Robinson, Ohio State Legal Services Association

Bruce McCrodden, National City Bank

Timothy Grendell, Ohio House of Representatives

2:30-2:45 **Break**

2:45-4:00 **Best Practices in Litigation and Community Education**

Moderator: Dennis Keating, Maxine Goodman Levin College of Urban Affairs

Litiqation Panel:

Steve Olden, Legal Aid Society of Cincinnati Diane Citrino, Housing Advocates, inc. Anita Lopez, Toledo Fair Housing Center

Moderator: Kent Smith

Community Education Panel

Andre Reynolds, Neighborhood Housing Services

Lisa Gold Scott, City of Cleveland

Uriah King, Miami Valley Fair Housing Center

Sheet1

City of Cleveland – HMDA data, 2005	Count	Market share	Related to local depository Count	Related to local depository Market share
Top Ten Home Purchase Lenders				
By Originations				
Total originations (NEOCANDO)	7,128			
ARGENT MORTGAGE COMPANY LLC	1,258	17.65%		
NEW CENTURY MORTGAGE CORPORATION	375	5.26%		
THIRD FEDERAL SAVINGS AND LOAN	358	5.02%	358	5.02%
AEGIS FUNDING CORPORATION	345	4.84%		
COUNTRYWIDE HOME LOANS	313	4.39%		
LONG BEACH MORTGAGE CO	305	4.28%		
CCO MORTGAGE CORP (CHARTER ONE)	232	3.25%	232	3.25%
NATIONAL CITY BANK OF INDIANA	210	2.95%	210	2.95%
FIFTH THIRD MORTGAGE COMPANY	206	2.89%	206	2.89%
WELLS FARGO BANK, NA	194	2.72%		
Subtotal, top ten	3,796	53.25%	1,006	14.11%
Top Ten Refinance Lenders				
By Originations				
Total originations (NEOCANDO)	6,994			
ARGENT MORTGAGE COMPANY LLC	1,165	16.66%		
COUNTRYWIDE HOME LOANS	409	5.85%		
THIRD FEDERAL SAVINGS AND LOAN	276	3.95%	276	3.95%
NEW CENTURY MORTGAGE CORPORATION	254	3.63%		
JPMORGAN CHASE BANK	229	3.27%	229	3.27%
PEOPLE'S CHOICE FINANCIAL CORP	224	3.20%		
HFC COMPANY LLC	203	2.90%		
AMERICAN HOME MORTGAGE CORP	166	2.37%		
BENEFICIAL HOMEOWNERS SERVICE	163	2.33%		
WELLS FARGO BANK, NA	153	2.19%		
Subtotal, top ten	3,242	46.35%	505	7.22%

COMBINED PURCHASE & REFINANCE	14,122			
ARGENT MORTGAGE COMPANY LLC	2,423	17.16%		
COUNTRYWIDE HOME LOANS	722	5.11%		
THIRD FEDERAL SAVINGS AND LOAN	634	4.49%	634	4.49%
NEW CENTURY MORTGAGE CORPORATION	629	4.45%		
WELLS FARGO BANK, NA	347	2.46%		
AEGIS FUNDING CORPORATION	345	2.44%		
LONG BEACH MORTGAGE CO	305	2.16%		
CCO MORTGAGE CORP (CHARTER ONE)	232	1.64%	232	1.64%
JPMORGAN CHASE BANK	229	1.62%	229	1.62%
PEOPLE'S CHOICE FINANCIAL CORP	224	1.59%		
NATIONAL CITY BANK OF INDIANA	210	1.49%	210	1.49%
FIFTH THIRD MORTGAGE COMPANY	206	1.46%	206	1.46%
HFC COMPANY LLC	203	1.44%		
AMERICAN HOME MORTGAGE CORP	166	1.18%		
BENEFICIAL HOMEOWNERS SERVICE	163	1.15%		
ALL	7,038	49.84%	1,511	10.70%
TOP 10	6,090	43.12%	1,095	7.75%

Source: Housing Research and Advocacy Center, City of Cleveland Community Lending Factbook, July 2007

Top 25 Lenders Ranked by Number of High-Cost Home Mortgage Loans
Cleveland, Ohio MSA
2006

Rank Institution	*Number of High-Cost Loans*	*Number of Non-High Cost Loans*	*Total Loans*	*High-Cost %*
1 NEW CENTURY MORTGAGE CORPORATION	1,731	100	1,831	94.54%
2 NATIONAL CITY BANK	**1,340**	**3,159**	**4,499**	**29.78%**
3 COUNTRYWIDE HOME LOANS	1,309	3,570	4,879	26.83%
4 ARGENT MORTGAGE COMPANY	1,001	38	1,039	96.34%
5 WELLS FARGO BANK, NA	816	1,895	2,711	30.10%
6 BNC MORTGAGE	617	37	654	94.34%
7 NOVASTAR MORTGAGE, INC.	614	16	630	97.46%
8 INTERVALE MORTGAGE	583	63	646	90.25%
9 OPTION ONE MORTGAGE CORP	580	15	595	97.48%
10 AMERICAN HOME MORTGAGE CORP.	523	744	1,267	41.28%
11 HFC COMPANY LLC	496	50	546	90.84%
12 SOUTHSTAR FUNDING, LLC	463	96	559	82.83%
13 WILMINGTON FINANCE, INC.	449	106	555	80.90%
14 AEGIS FUNDING CORPORATION	448	9	457	98.03%
15 CHASE MANHATTAN BANK USA, NA	**440**	**47**	**487**	**90.35%**
16 BENEFICIAL COMPANY LLC	422	124	546	77.29%
17 ACCREDITED HOME LENDERS, INC	419	17	436	96.10%
18 LONG BEACH MORTGAGE CO.	384	3	387	99.22%
19 QUICKEN LOANS	359	1,108	1,467	24.47%
20 CITIFINANCIAL, INC.	344	32	376	91.49%
21 INDYMAC BANK, F.S.B.	339	271	610	55.57%
22 SUNTRUST MORTGAGE, INC	331	729	1,060	31.23%
23 EQUIFIRST CORPORATION	291	17	308	94.48%
24 WELLS FARGO FIN'L OHIO 1, INC	283	40	323	87.62%
25 FREMONT INVESTMENT & LOAN	273	9	282	96.81%
Loans by depositories	**1,780**	**3,206**	**4,986**	**35.70%**
Loans by Top 25	14,855	12,295	27,150	54.71%
Depository % of top 25	11.98%	26.08%	18.36%	

Bold type = local depository bank affiliate

Source: 2006 HMDA Data
Prepared by: Housing Research & Advocacy Center

National
Urban League

Empowering Communities.
Changing Lives.

TESTIMONY OF
THE HONORABLE MARC H. MORIAL
PRESIDENT AND CEO
NATIONAL URBAN LEAGUE
BEFORE FOR THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
THURSDAY, OCTOBER 16, 2008

Chairman Dodd, Ranking Member Shelby, thank you for this opportunity to testify today to set the record straight about what I call the Financial Weapon of Mass Deception: the ugly and insidious and concerted effort to blame minority borrowers for the nation's current economic straits.

This Financial Weapon of Mass Deception – as false and outrageous as it is – has taken hold, thanks to constant and organized repetition and dissemination throughout the media and political circles.

This is not a harmless lie, an innocuous stretching of the truth for some fleeting political advantage. It is an enormously damaging and far-reaching smear designed to shift the blame for this crisis from Wall Street and Washington, where it belongs, onto middle class families on Main Street and Martin Luther King Boulevard who are most victimized by their excesses.

For years, the National Urban League and others in the civil rights community have raised the red flag and urged Congress and the Administration to address the predatory lending practices that were plaguing our communities. For example, in March of 2007, I issued the Homebuyers Bill of Rights in which I called upon government to clamp down on predatory lending and other practices that were undermining minority homebuyer. Unfortunately, my call went unheeded until disaster struck.

Now that disaster has struck, many of those who caused it are trying to blame the minority community and measures that helped to clear the way for qualified minorities to purchase homes – most notably the Community Reinvestment Act (CRA). In fact, it was the failure of regulatory policy and oversight that led to this debacle.

Let's start with the plain and simple facts:

1. **Wall Street investors – not Fannie Mae and Freddie Mac - were the major purchasers/investors of subprime loans** between 2004 and 2007, the period for which this data is available.

2. While minorities and low-income borrowers received a disproportionate share of subprime loans, **the vast majority of subprime loans went to white and middle and**

upper income borrowers. The true racial dimensions of the housing crisis have been reported in a number of outlets, including the New York Times.

3. **African-Americans and Hispanics were given subprime loans disproportionately compared to whites,** according to ComplianceTech, leading experts in lending to financial services companies. Also, African-American borrowers are more than twice as likely to receive subprime loans as white borrowers.

Furthermore, according to a detailed analysis by ComplianceTech:

- In each year between 2004-2007, non-Hispanic whites had more subprime rate loans **than all minorities combined**;
- In 2007, 37.3% of African American borrowers were given subprime loans, versus 14.21% of whites, according to ComplianceTech. More than 53% of African-American borrowers were given subprime loans compared with 21% of whites, according to the National Urban League's *Equality Index* published in our 2008 *State of Black America* report,
- The vast majority of subprime rate loans were originated in **largely white census tracts**, i.e., census tracts less than 30% minority;
- The volume of **subprime rate loans made to non-Hispanic whites dwarfs** the volume of **subprime rate loans made to minorities**;
- In each year, **the white proportion of subprime rate loans was lower than all minorities,** except Asians;
- **Upper income borrowers had the highest share** of subprime rate loans during each year except 2004, where middle income borrowers had the highest share;
- Contrary to popular belief, **low income borrowers had the lowest share of subprime rate loans.**
- It is becoming clearer everyday that a large number of people who ended up with subprime loans could have qualified for a prime loan. That's where the abuse lies;
- **Non-CRA financial services companies were major originators of subprime loans** between 2004 and 2007, the period for which data is available.

These facts are unequivocal. They are clear. They are indisputable.

Yet these facts are being buried in an avalanche of false accusations, scapegoating and downright lies being spread by the purveyors of the Financial Weapon of Mass Deception. Conservative commentators from Fox News commentator Neil Cavuto to ABC News analyst George Will to Washington Post columnist Charles Krauthammer have fanned out across the airwaves, talking points in hand, telling the world that this crisis is NOT the result of a failure of regulation but the fault of minority borrowers who bit off more than they could chew.

Charles Krauthammer tells us that "[f]or decades, starting with Jimmy Carter's Community Reinvestment Act of 1977 . . . led to tremendous pressure to . . . extend mortgages to people who were borrowing over their heads. That's called subprime lending. It lies at the root of our current calamity."

George Will tells us that regulation: "criminalize[d] as racism and discrimination if you didn't lend to unproductive borrowers. Fannie Mae and Freddie Mac existed to gibber – to rig the housing market because the market would not have put people into homes they could not afford."

And even right here in the halls of Congress, echoes this same, false refrain, as we heard from Rep. Michele Bachman of Minnesota (R-Minn), who added Congressional weight to this myth when she quoted an Investor's Business Daily article from the floor of the House that said banks made loans "on the basis of race and little else."

As seen in the attached internet blogs from highly trafficked sites, this baseless blame game has turned into vicious attacks on African-Americans, Hispanics, Jews and Gays and Lesbians.

In the last few weeks, I have undertaken an aggressive campaign directed at the nation's financial leaders to dispel this myth. In letters to Treasury Secretary Henry Paulson and Federal Reserve Chairman, Benjamin Bernanke, I have asked that they both publicly refute claims by some conservative pundits and politicians that most of the defaulted subprime loans at the root of the crisis were made to African-Americans, Hispanics and other so-called "unproductive borrowers."

On the basis of hearsay, rumors and misinformation, seeds of division are being sown all across the United States in a volatile political environment where Americans are terrified by the economic situation. History provides too many lessons on the consequences of singling out only certain segments of the population as culprits for a country's woes for us not to do all within our power to stop this ugly and insidious smear campaign in its tracks.

I urge you, in the strongest possible terms, to join me in standing up to this big lie, this Financial Weapon of Mass Deception. It is your duty to stop the precious waste of time and energy being spent on blaming the victims and force a healthy debate on what must be done to curb too much Wall Street greed and too little Washington oversight. This hearing is an important step toward that end and I applaud you for holding it.

I call upon you to join with me to ensure that innocent people in our community who look to you for protection are not further scapegoated, victimized and exploited by unscrupulous and greedy players and those who do their bidding.

I call upon you to not allow yourselves to be distracted by the attempts to undercut the Community Reinvestment Act and undermine regulatory reform.

I call upon you to stay focused and to take strong and positive steps to strengthen our communities and the nation's financial foundation through regulatory reform.

I call upon you to do your part to disarm this false and dangerous Financial Weapon of Mass Deception.

In this time of global crisis, we must bring Americans together and not continue to divide ourselves with false racial arguments.

Please enter my testimony into the record.

Thank you.

McClatchy Washington Bureau

Print This Article

Posted on Sun, Oct. 12, 2008

Private sector loans, not Fannie or Freddie, triggered crisis

David Goldstein and Kevin G. Hall | McClatchy Newspapers

last updated: October 12, 2008 10:13:10 PM

WASHINGTON — As the economy worsens and Election Day approaches, a conservative campaign that blames the global financial crisis on a government push to make housing more affordable to lower-class Americans has taken off on talk radio and e-mail.

Commentators say that's what triggered the stock market meltdown and the freeze on credit. They've specifically targeted the mortgage finance giants Fannie Mae and Freddie Mac, which the federal government seized on Sept. 6, contending that lending to poor and minority Americans caused Fannie's and Freddie's financial problems.

Federal housing data reveal that the charges aren't true, and that the private sector, not the government or government-backed companies, was behind the soaring subprime lending at the core of the crisis.

Subprime lending offered high-cost loans to the weakest borrowers during the housing boom that lasted from 2001 to 2007. Subprime lending was at its height from 2004 to 2006.

Federal Reserve Board data show that:

- More than 84 percent of the subprime mortgages in 2006 were issued by private lending institutions.
- Private firms made nearly 83 percent of the subprime loans to low- and moderate-income borrowers that year.
- Only one of the top 25 subprime lenders in 2006 was directly subject to the housing law that's being lambasted by conservative critics.

The "turmoil in financial markets clearly was triggered by a dramatic weakening of underwriting standards for U.S. subprime mortgages, beginning in late 2004 and extending into 2007," the President's Working Group on Financial Markets reported Friday.

Conservative critics claim that the Clinton administration pushed Fannie Mae and Freddie Mac to make home ownership more available to riskier borrowers with little concern for their ability to pay the mortgages.

"I don't remember a clarion call that said Fannie and Freddie are a disaster. Loaning to minorities and risky folks is a disaster," said Neil Cavuto of Fox News.

Fannie, the Federal National Mortgage Association, and Freddie, the Federal Home Loan Mortgage Corp., don't lend money, to minorities or anyone else, however. They purchase loans from the private lenders who actually underwrite the loans.

It's a process called securitization, and by passing on the loans, banks have more capital on hand so they can lend even more.

This much is true. In an effort to promote affordable home ownership for minorities and rural whites, the Department of Housing and Urban Development set targets for Fannie and Freddie in 1992 to purchase low-income loans for sale into the secondary market that eventually reached this number: 52 percent of loans given to low-to moderate-income families.

To be sure, encouraging lower-income Americans to become homeowners gave unsophisticated borrowers and unscrupulous lenders and mortgage brokers more chances to turn dreams of homeownership in nightmares.

But these loans, and those to low- and moderate-income families represent a small portion of overall lending. And at the height of the housing boom in 2005 and 2006, Republicans and their party's standard bearer, President Bush, didn't criticize any sort of lending, frequently boasting that they were presiding over the highest-ever rates of U.S. homeownership.

Between 2004 and 2006, when subprime lending was exploding, Fannie and Freddie went from holding a high of 48 percent of the subprime loans that were sold into the secondary market to holding about 24 percent, according to data from Inside Mortgage Finance, a specialty publication. One reason is that Fannie and Freddie were subject to tougher standards than many of the unregulated players in the private sector who weakened lending standards, most of whom have gone bankrupt or are now in deep trouble.

During those same explosive three years, private investment banks — not Fannie and Freddie — dominated the mortgage loans that were packaged and sold into the secondary mortgage market. In 2005 and 2006, the private sector securitized almost two thirds of all U.S. mortgages, supplanting Fannie and Freddie, according to a number of specialty publications that track this data.

In 1999, the year many critics charge that the Clinton administration pressured Fannie and Freddie, the private sector sold into the secondary market just 18 percent of all mortgages.

Fueled by low interest rates and cheap credit, home prices between 2001 and 2007 galloped beyond anything ever seen, and that fueled demand for mortgage-backed securities, the technical term for mortgages that are sold to a company, usually an investment bank, which then pools and sells them into the secondary mortgage market.

About 70 percent of all U.S. mortgages are in this secondary mortgage market, according to the Federal Reserve.

Conservative critics also blame the subprime lending mess on the Community Reinvestment Act, a 31-year-old law aimed at freeing credit for underserved neighborhoods.

Congress created the CRA in 1977 to reverse years of redlining and other restrictive banking practices that locked the poor, and especially minorities, out of homeownership and the tax breaks and wealth creation it affords. The CRA requires federally regulated and insured financial institutions to show that they're lending and investing in their communities.

Conservative columnist Charles Krauthammer wrote recently that while the goal of the CRA was admirable, "it led to tremendous pressure on Fannie Mae and Freddie Mac — who in turn pressured banks and other lenders — to extend mortgages to people who were borrowing over their heads. That's called subprime lending. It lies at the root of our current calamity."

Fannie and Freddie, however, didn't pressure lenders to sell them more loans; they struggled to keep pace with their private sector competitors. In fact, their regulator, the Office of Federal Housing Enterprise Oversight, imposed new restrictions in 2006 that led to Fannie and Freddie losing even more market share in the booming subprime market.

What's more, only commercial banks and thrifts must follow CRA rules. The investment banks don't, nor did the now-bankrupt non-bank lenders such as New Century Financial Corp. and Ameriquest that underwrote most of the subprime loans.

These private non-bank lenders enjoyed a regulatory gap, allowing them to be regulated by 50 different state banking supervisors instead of the federal government. And mortgage brokers, who also weren't subject to federal regulation or the CRA, originated most of the subprime loans.

In a speech last March, Janet Yellen, the president of the Federal Reserve Bank of San Francisco, debunked the notion that the push for affordable housing created today's problems.

"Most of the loans made by depository institutions examined under the CRA have not been higher-priced loans," she said. "The CRA has increased the volume of responsible lending to low- and moderate-income households."

In a book on the sub-prime lending collapse published in June 2007, the late Federal Reserve Governor Ed Gramlich wrote that only one-third of all CRA loans had interest rates high enough to be considered sub-prime and that to the pleasant surprise of commercial banks there were low default rates. Banks that participated in CRA lending had found, he wrote, "that this new lending is good business."

McClatchy Newspapers 2008

The New York Times
nytimes.com

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August 3, 2008

MORTGAGES

Subprime Loans' Wide Reach

By BOB TEDESCHI

WHILE subprime loans deeply penetrated low-income and minority groups, a new study suggests that more upper-income borrowers and more whites took out such loans than any other groups.

Compliance Technologies, a lending-industry consultancy, last month analyzed more than 1.9 million subprime loans originated in 2006, the height of the subprime lending frenzy, and found that roughly 56 percent went to non-Hispanic whites. Affluent borrowers, those with annual income at least 120 percent of their given area's median income, meanwhile, took out more than 39 percent of the loans.

"I was surprised to see that non-Hispanic whites received more subprime loans than all minority groups combined," said Maurice Jourdain-Earl, a founder and managing director of Compliance Technologies.

Still, African-Americans and Hispanics received subprime loans in a greater proportion than whites. Whites made up 71 percent of the borrower population in 2006 and received 56 percent of the subprime loans originated that year. Blacks, meanwhile, made up 10 percent of the loan pool, yet received 19 percent of the subprime loans. Hispanics constituted 14 percent of the borrower community and received 20 percent of the subprime loans.

The reasons behind the disparities have been hotly debated. Some lenders have argued that minority populations were merely less creditworthy than whites, while some minority advocates claim lenders and brokers discriminated on the basis of race. Mr. Jourdain-Earl, whose company is minority owned, did not speculate on the cause.

Researchers in the lending industry have not tracked how well members of different demographic groups have kept pace with subprime loans made in 2006. Lenders keep such data, but they have not shared it publicly.

Of the subprime loans made in the New York metropolitan area, 80 percent went to upper-income people, defined as those with incomes greater than $71,000, and blacks, Hispanics and whites received such loans in roughly similar numbers.

But more than two-thirds of those subprime loans — defined as mortgages with annual percentage rates at least three points higher than those given to prime borrowers — were made in predominantly minority neighborhoods. Depending on how well, or poorly, such borrowers handle their subprime mortgages, such neighborhoods could fare much worse than predominantly white areas.

So far, though, the results are mixed. While some predominantly minority areas in Nassau County have indeed seen foreclosures spike, foreclosure rates in other predominantly minority areas, like Harlem, have held fairly steady. According to RealtyTrac, a real estate industry statistical firm, monthly foreclosure-related filings in west Harlem in the first six months of this year, for instance, are only slightly higher than they were a year earlier but actually lower than during the same period in 2006.

Debbie Gruenstein Bocean, a researcher with the Center for Responsible Lending, and the author of a 2006 report suggesting that lenders offered higher-cost subprime loans to minority applicants than to whites, said she "did not dispute" the findings of Mr. Jourdain-Earl's report.

"The subprime crisis is not limited to the poor and nonwhite," Ms. Bocean said.

But, she said, it will hit nonwhites and lower-income families in general much harder. With fewer financial resources, less affluent borrowers are more likely to lose their homes, she said.

Testimony of Eric Stein
Center for Responsible Lending

Before the U.S. Senate
Committee on Banking, Housing and Urban Affairs

"Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis"

October 16, 2008

Good morning Chairman Dodd, Ranking Member Shelby, and members of the Committee. Thank you for holding this hearing on the causes of the financial crisis and for inviting me to testify.

Introduction

I am Eric Stein, senior vice president of the Center For Responsible Lending (CRL), (www.responsiblelending.org), a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help (www.self-help.org), a nonprofit community development financial institution that consists of a credit union and a non-profit loan fund, of which I am also chief operating officer.

For close to thirty years, Self-Help has focused on creating ownership opportunities for low-wealth families, primarily through financing home loans to low-income and minority families who otherwise might not have been able to get home loans. In other words, we work to provide fair and sensible loans to the people most frequently targeted for predatory and abusive subprime mortgages. In total, Self-Help has provided over $5 billion of financing to 55,000 low-wealth families, small businesses and nonprofit organizations in North Carolina and across America. Self-Help's lending record includes our secondary market program, which encourages other lenders to make sustainable loans to borrowers with blemished credit. Self-Help buys these loans from banks, holds on to the credit risk, and resells them to Fannie Mae. Self-Help's loans that have performed well—our loan losses have been under 1% per year—and increased these families' wealth.

In February 2007, Self-Help's CEO appeared before this Committee and called the subprime market "a quiet but devastating disaster." In that testimony, he outlined our research that showed the subprime mortgage market was heading toward a destructive rate of foreclosures—a projection, at the time, that was called "wildly pessimistic."[1] Given the current financial crisis, which is much broader in scope and more severe than we had foreseen, we wish that charge had been true.

Solutions:

Because at bottom the problem is rooted in excessive foreclosures of unsustainable loans, the solutions must address this problem. Foreclosures are a tragic event in the lives of a family losing their home, but it does not affect them alone – neighbors lose property value and increase the likelihood that they too will be foreclosed on; municipalities lose tax revenue just when demand for their services rises to deal with vacant homes and greater crime; and the economy loses purchasing power when it can least afford it. Voluntary loan modifications have not prevented the foreclosure crisis from escalating. I discuss additional solutions below, but I would like to focus on five:

- Congress should lift the ban on judicial loan modifications, which would prevent hundreds of thousands of foreclosures without costing the taxpayer at all. A loan on a family's primary residence is the only debt that cannot be restructured in a chapter 13 bankruptcy, even though investment banks like Lehman have this ability; courts need the authority to modify loans when families can afford a market rate mortgage when voluntary modifications cannot be accomplished.

- Treasury should embark on a concentrated, multi-pronged effort to increase affordable loan modifications made through the Troubled Asset Relief Program (TARP). A key recommendation is to use TARP's authority to embark on streamlined modifications similar to what FDIC has done with loans owned by IndyMac, targeting the 34% debt-to-income ratio that is part of the recent settlement of state Attorneys General and Bank of America over Countrywide's practices. Treasury should require this structure from banks it purchases assets from, invests equity in, and use it when the government controls whole loans or guarantees modified loans.

- Congress should merge the Office of Thrift Supervision into the Office of the Comptroller of the Currency, eliminate the thrift charter and transfer the holding companies to the Federal Reserve. The OTS has proven not up to the task to protecting consumers or the public from abusive lending practices.

- The Federal Reserve should extend its HOEPA rule to prohibit yield-spread premiums on subprime and nontraditional mortgages, and extend the protections provided for subprime to nontraditional loans.

- Congress should pass the Homeownership Preservation and Protection Act (S 2452) sponsored by Senator Dodd. As this Committee is aware, this bill would establish new protections for consumers and stop many of the abuses discussed in this testimony. Critically, Congress should ensure that assignee liability provisions in the bill are retained in order to realign the perverse incentives that encourage unsustainable loans. Passage of this bill into law would go a long way in restoring consumer and investor confidence, which will be essential in achieving a full economic recovery.

Causes:

In my testimony, I will discuss four key points regarding the causes of the crisis:

1. Dangerous lending greatly inflated the housing bubble, and the resulting foreclosures are magnifying the damage of the bubble's collapse.

During the current decade, the volume of subprime and Alt A lending expanded tremendously as Wall Street securitized these loans and made virtually unlimited capital available to subprime lenders. To increase loan volume, lenders adopted even riskier practices and products, such as loans that produced high payment shock. These loans were packaged into private-label securities that received AAA ratings from the rating agencies.

This surge in lending spurred historically high house appreciation—the housing bubble. At the same time, this appreciation temporarily hid the long-term unsustainability of these mortgages, as lenders refinanced troubled loans using the home equity gained from higher housing prices. In fact, when borrowers expressed concerns about future payment increases, lenders routinely told them not to worry about it, since they could always refinance.

The rest of the story is well known. The bursting of a housing bubble is always a painful economic event, but the effects of today's falling prices are severely exacerbated by millions of needlessly dangerous mortgages that have failed, or are poised to fail. Refinances became scarce, and unsustainable mortgages turned into the massive foreclosures we are continuing to see today.

Loan modifications can adjust these mortgages to bring them in line with the real market value of the property, but voluntary modifications have not restructured unsustainable loans in nearly great enough numbers.

2. The central cause of this dangerous lending was Wall Street demand for the riskiest, highest-cost loans. That is where blame is primarily due. Wall Street was aided by lenders responding to that demand and credit ratings agencies that provided high ratings on demand.

With all the complexity of today's financial crisis, it's easy to lose sight of the fact that this began in the late 1990s with subprime lending, when subprime lenders put increasing numbers of families into expensive and unnecessarily risky home loans, most often refinances of existing loans.[2]

The fact that Wall Street paid the most for the most dangerous mortgages meant that originators provided these loans, often regardless of their ultimate sustainability. As a result, lenders like Countrywide had pricing policies to pay originators more if the put borrowers in more dangerous loans, rather than safer ones. Unsurprisingly, the loans more likely to result in foreclosure were the ones that were originated, generally at higher rates than the borrower qualified for. These loans were then packaged into private-label securities that received AAA ratings from the rating agencies, who were being paid by the very issuers of the securities.

3. This lending binge was abetted by regulators who ignored the risks.

This great experiment in subprime and Alt A securitization took place largely unhindered by any meaningful rules. Imagine a scenario where the most dangerous intersections have no traffic signals. When the police are asked to intervene, they decline, saying they don't want to stop the free flow of traffic. Meanwhile, the collisions keep piling up until the wreckage is a problem for everyone.

When advocates or lawmakers suggested strengthening oversight on the sector providing the riskiest home loans, the inevitable response was, "We don't want to stop the free flow of credit." Unfortunately, the ideology that lending should not be restrained at any cost infected most agencies, particularly the Federal Reserve under Chairman Greenspan, who had the power to issue rules outlawing unfair and deceptive mortgages across the country, and the Office of Thrift Supervision. Today it is abundantly clear that the *lack* of common-sense rules—which should have been applied by agencies with specific duties to ensure safety and soundness in the market and protect families—has impeded the flow of credit beyond anyone's wildest dreams.

4. The architects of this crisis are seeking to divert attention from their own culpability by blaming the Community Reinvestment Act (CRA), homeowners, and the government-sponsored enterprises (GSEs) trying to meet their housing goals.

CRA was passed in 1977, and neither requires nor governs subprime lending, and it doesn't even apply to most originators who supplied subprime loans. Although there were borrowers who knowingly overreached on their loans, Wall Street's demand created an environment where lenders were all too ready to convince borrowers to take complicated loans few families understood. Investment banks led the development of the subprime market. While Fannie Mae and Freddie Mac did invest in the marketable senior tranches of subprime securities that were created by Wall Street, their credit losses have primarily come from Alt A loans made to higher income borrowers, which has nothing to do with their affordable housing goals. Further, had they not stepped up to support the housing market when private securitizations ground to a halt, our economy would be in substantially worse shape than it is now.

I. SOLUTIONS

The gravity of the current crisis underscores the need for systemic changes to be made to prevent another one. The most urgently needed actions are those that will, in the very near-term, stop the vicious cycle of falling home values and foreclosures. We recommend the legislative and administrative actions we believe will do so most effectively. In addition, in Appendix B, we set forth three fundamental principles that must guide any longer-term solutions.

A. CRITICAL IMMEDIATE ACTIONS NEEDED

The most pressing actions needed today are those that will assist existing homeowners to stay in their homes and, by extension, help their neighbors and the financial system as a whole—since financial institutions will not survive if their loan-related portfolios continue to hemorrhage.

We recommend several key actions:
(1) lifting the ban on judicial loan modifications of mortgages on principal residences;
(2) several administrative actions to ensure the Troubled Asset Relief Program (TARP) results in as many loan modifications as possible;
(3) additional legislative actions to make TARP more effective;
(4) and other legislative actions to induce loan modifications.

1. Congress should lift the ban on judicial loan modifications, which would prevent hundreds of thousands of foreclosures without costing the taxpayer at all.[3]

The most effective action Congress can take to immediately stem the tide of foreclosures, and *at zero cost to the U.S. taxpayer*, is to lift the ban on judicial loan modifications for primary residences. Judicial modification of loans is available for owners of commercial real estate and yachts, as well as subprime lenders like New Century or investment banks like Lehman Bros., but is denied to families whose most important asset is the home they live in. In fact, current law makes a mortgage on a primary residence the only debt that bankruptcy courts are <u>not</u> permitted to modify in chapter 13 payment plans.

Judicial modification would provide judges the authority to modify mortgages and would help more than 600,000 families stuck in bad loans keep their homes. Current proposals provide that modifications would narrowly target families who would otherwise lose their homes and exclude families who do not need assistance.[4] They would also provide courts with only limited discretion—interest rates must be set at commercially reasonable, market rates; the loan term may not exceed 40 years, and the principal balance may not be reduced below the value of the property. Judicial modifications would also help maintain property values for families who live near homes at risk of foreclosure. And it would complement programs that rely on voluntary loan modifications or servicer agreement to refinance for less than the full outstanding loan balance.

Voluntary modifications and refinancings are the goal. Judicial loan modification would induce more voluntary modifications outside bankruptcy because everyone would know the alternative,[5] thereby removing the obstacles posed by threat of investor lawsuits. And if the servicer agrees to a sustainable modification, the borrower will not qualify for bankruptcy relief because they will fail the eligibility means test. As Lewis Ranieri, founder of Hyperion Equity Funds and generally considered "the father of the securitized mortgage market,"[6] has recently noted, such relief is the only way to break through the problem posed by second mortgages.[7]

2. **Treasury should embark on a concentrated, multi-pronged effort to increase affordable loan modifications made through the Troubled Asset Relief Program (TARP).**

The recently passed TARP did not go far enough to ensure sustainable modifications. Lifting the ban on judicial loan modifications should have been included in the package, and, at the very least, the legislative provisions discussed in section 6 below. However, TARP can still be used as a powerful tool to stem foreclosures if Treasury promptly takes the following actions:

- ***Require an FDIC-like modification plan for all home loans owned by any bank in which Treasury purchases an equity interest or securities***. Treasury should use TARP's authority to embark on streamlined modifications similar to what FDIC has done with loans owned by IndyMac, targeting the 34% debt-to-income ratio that is part of the recent settlement of state Attorneys General and Bank of America over Countrywide's practices. Treasury should require this structure from banks it purchases assets from or invests equity in.

- ***Continue and expand these efforts to modify loans within the control of the government*** by purchasing whole loans when possible and modifying loans owned or controlled by Fannie Mae and Freddie Mac. The GSEs are already becoming more aggressive in their modifications and are working with the FDIC where they are the investor in IndyMac loans. The government should be making similar efforts across the board, with all loans they own or control.

- ***Use the new guarantee authority to provide guarantees to sustainable modifications.*** TARP allows Treasury to guarantee modified loans. Such guarantee could provide significant incentives for modification, perhaps great enough for servicers and trustees to convince investors to liberalize any restrictions against modifying in the Pooling and Servicing Agreements (PSAs), and will require a lower expenditure of funds than buying the loans directly. To be worth the risk to taxpayers, however, Treasury must condition its guarantee on meeting sustainability standards for modification—for example, a payment reduction of at least 10 %; a debt-to-income ratio on housing debt post modification of no more than 34 %; an interest rate reduction for the life of the loan; principal reduction to 95% of current value; and settlement on any second mortgage. This approach is similar to the Hope for Homeowners program, though the transaction costs on a modification/guarantee should be lower than an FHA refinance.

- ***Buy servicing rights***. Treasury can break the modification logjam presently caused by understaffed and sometimes uncooperative servicers. Unless we can change restrictive PSA's that govern servicer discretion to modify, the initial focus should be to buy master servicing rights where the PSAs provide the servicer with more flexibility. Master servicing rights shouldn't cost more than about 1% of the outstanding balance and are an eligible "troubled asset" under TARP.

- ***Purchase second mortgages to gain control of them*** so that they can be consolidated with the first mortgages and restructured. Second mortgages are one of the greatest obstacles to modifications because a first mortgage holder will not generally voluntarily reduce interest or principal only to increase return for a second mortgage holder or cure its loan if the borrower is still in default on a second. Yet most second liens are underwater and could be purchased cheaply. To achieve this, Treasury must identify the owner of the first mortgages and coordinate efforts or buying the second mortgages won't result in modifications of the firsts.

- ***Establish a section within Treasury to lead the loan modification efforts***.

- ***Set specific goals for sustainable modifications with detailed reporting to increase transparency.***

3. Congress should merge the Office of Thrift Supervision into the Office of the Comptroller of the Currency, eliminate the thrift charter and transfer the holding companies to the Federal Reserve.

CRL supports the Treasury Department's proposal to phase out the thrift charter over a two-year period and merge OTS into the OCC. Eliminating OTS won't cure all of the banking system's regulatory ills. But it would eliminate one of the perverse consequences of the current "regulatory bazaar"—in which regulated institutions get to shop for their regulators—and be an important step in the overall effort to fix the nation's broken regulatory system.

We emphasize that CRL believes that improving the federal regulatory scheme shouldn't require sacrificing of the dual state-federal banking system. The modest number of state-licensed thrifts operate efficiently and are small enough that state regulators have adequate resources to oversee them. State licensing also can serve as a counter to the massive consolidation that's now happening in the banking industry; it will preserve smaller financial institutions that are sensitive to concerns of local communities, provide cost-effective choices for consumers and serve as a bulwark against anti-competitive practices.

4. The Federal Reserve should extend its HOEPA rule to prohibit yield-spread premiums on subprime and nontraditional mortgages, and extend the protections provided for subprime to nontraditional loans.

In July of this year, the Federal Reserve Board (the Board) finally exercised its authority under HOEPA to prohibit unfair and deceptive practices. Its rule addresses some of the most destructive practices leading to this crisis by requiring, for subprime loans, lenders to evaluate a borrower's ability to repay; reining in abusive prepayment penalties on short-term subprime ARMs; and requiring escrowing for taxes and insurance. We commend Chairman Bernanke, the Board and the staff that worked on the rule for these actions. To help prevent further abusive lending, however, the Board must (i) address broker incentives to provide worse loans than borrowers qualify by prohibiting abusive yield-spread premiums and (ii) extend protections provided for subprime loans to nontraditional mortgages as well.

5. **Congress should pass the Homeownership Preservation and Protection Act (S 2452) sponsored by Senator Dodd and establish assignee liability.**

As this Committee is aware, S 2452 would address many of the abuses discussed in this testimony by, among other provisions, (i) prohibiting steering prime borrowers into more expensive subprime loans; (ii) creating a duty for mortgage brokers to consider the best interests of their clients (iii) providing for a duty of good faith and fair dealing toward borrowers for all lenders; (iv) extending the Board's ability to repay requirement to cover nontraditional loans; (v) prohibiting prepayment penalties and yield-spread premiums on all subprime and nontraditional loans; and (vi) allowing state attorneys general to enforce the provisions of the law and not overriding state laws. <u>Specific</u> and <u>enforceable</u> protections such as these are essential to protecting families' most important, and least protected, transaction.

Critically, the bill also takes important steps toward ensuring everyone has skin in the game all the way up the chain by providing for assignee liability. We have now learned beyond a shadow of a doubt that Wall Street will incent loan structures best for their short term profits, unrelated to long-term borrower interests, and that originators will supply the loans for which they are paid the most. It is also clear that regulators are not up to task of policing millions of thousands of loan originations.

The best way to re-align the interests of borrowers and lenders is for Congress to insist on meaningful assignee liability.[8] When assignee liability exists, the borrower is allowed to pursue legal claims against the assignee when the loan transaction involves illegal actions or abusive terms. In the case of the mortgage market, strong assignee liability would mean that when a trust purchases mortgages, with all the corresponding financial benefits, it also accepts reasonable liability for when the mortgages prove to be abusive and harm homeowners, and therefore the investors will pay a financial price.

Assignee liability can be tightly drawn but must satisfy the principle that an innocent borrower who has received an illegal loan must be able to defend that loan in foreclosure as compared with an equally innocent assignee. This is for two reasons: first, the assignee can spread this loss across thousands of other loans, while the borrower has but one home. Second, the assignee can choose who to buy their loans from; as a result, they can choose only reputable originators likely to make quality mortgages that are strong enough to purchase the loan back if it violates representations warranties that the secondary market purchaser imposes.

Public enforcement can never be adequate: there is a shortage of resources to match against the millions of loans made to borrowers, and in some cases, a lack of will to take significant action. Investigations will inevitably be too slow for the homeowners who face foreclosure in the meantime, and while public enforcement can achieve some relief, it will rarely, if ever, be enough to make most individual borrowers whole. Assignee liability effectively uses the market to decentralize oversight of loans purchased—no one will better ensure that loans are originated to specified standards than investors who carry the associated financial and legal risk.

Assignee liability also helps to protect responsible investors from misperceived risks and provides incentives for the market to police itself, curbing market inefficiencies. And assignee liability is not a new concept; it exists in several other contexts related to lending.[9]

6. Additional legislative actions should be taken to induce loan modifications.

The following additional legislative actions should also be taken, either by modifying TARP or otherwise, to induce loan modifications:

Pursuant to TARP:

- ***Change rules governing trusts so that the government can purchase whole loans out of securities.*** The biggest problem with TARP with respect to loan modifications is that 80% of recent subprime and Alt A loans were securitized, and by purchasing securities, the government will own just a partial interest in the cash flow generated by loans, giving it no greater rights to modify loans than other owners scattered around the globe. If the government could buy whole loans, it would have the discretion to do modifications similar to what FDIC has done with IndyMac's portfolio. However, trusts are designed to be passive entities and are not permitted to sell whole loans, even though they have some flexibility to modify them or accept a refinance for less than the principal balance.

  Congress should pass legislation clarifying that participation in a government-sponsored whole loan purchase program would be permitted under Real Estate Mortgage Investment Conduit (REMIC) tax rules. Congress could further provide that continued REMIC status (and future tax benefits) is contingent on PSAs being modified to permit (but not require) participation in the loan sale process. Finally, Congress, the SEC or Financial Accounting Standards Board would need to ensure that accounting standards change to permit these sales. Clearly, having whole loans that servicers for whatever reason are unable to modify, that will cause needless foreclosures, and that Treasury cannot purchase even though it could restructure the loans to make them affordable to the borrowers and maximize the return to the government, is not socially optimal. There should be no objection freeing servicers to modify or sell these assets at the direction of a Treasury program.[10]

- ***Amend TARP to provide for meaningful protection for servicers when they modify loans.*** One obstacle to servicers modifying loans is that they fear lawsuits by investors harmed by their decision; any modification will favor some investors and disfavor others. TARP attempts to deal with this problem by making clear that servicers owe their duty to investors as a whole, not to any particular class of investors who may be harmed by a modification. However, TARP includes the exception "Except as established in any contract." Congress should delete this phrase in order to provide servicers greater comfort.

  Alternatively, Congress could enact a narrowly tailored indemnification provision for servicers who act reasonably in modifying or selling any loan under the Treasury program. Either change should increase servicers' willingness to modify in the face of particular investor objections.

Other legislative actions to induce modifications:

- ***Incent servicers to provide sustainable loan modifications.*** As a counterweight to the reality that most servicing contracts compensate servicers more for foreclosure than modification, Congress could fund a program to pay servicers up to say $1,500 for each modification that meets certain standards of effectiveness.

- ***Require servicers to engage in reasonable loss mitigation strategies.*** Congress should require that mortgage loan servicing companies pursue loss mitigation strategies in every instance prior to initiating foreclosures.

- ***Ensure income tax burdens do not undermine sustainability of loan modifications.*** Right now, when a provides a homeowner with a loan modification containing a principal writedown (the type of writedown contemplated to occur under the new FHA Hope for Homeowners program), the IRS considers the homeowner to have received taxable cancellation of indebtedness income unless the mortgage debt is "qualified" under the terms of the Mortgage Forgiveness Debt Relief Act of 2007 or the homeowner is insolvent. In many instances, especially where the difference between the original loan amount and the current value of the house is large, the prospect of tax liability could discourage homeowners from participating in Hope for Homeowners or similar programs, or, if such a modification is obtained, resulting tax liability could cause the homeowner to redefault on the loan. To prevent this perverse result, Congress should amend the Mortgage Forgiveness Debt Relief Act of 2007 in two ways: (1) lenders should not be required to file Form 1099 with the IRS when cancelling any mortgage-related debt; and (2) the definition of "qualified mortgage debt" should be extended to include all mortgage debt, not just acquisition debt.

B. THINKING LONGER TERM: FUNDAMENTAL PRINCIPLES ESSENTIAL TO A PROPERLY FUNCTIONING MARKET

In addition to immediate actions needed to stem foreclosures, long-term systemic changes are also needed. The following three principles, essential to the long-term health of the mortgage market and the financial system as a whole, should serve as guiding posts for longer-term reform: (1) sustainable mortgages based on sound underwriting; (2) alignment of market incentives (including assignee liability); and (3) adequate oversight. Further discussion of these principles is provided as Appendix B.

II. THE HOUSING BUBBLE AND UNSUSTAINABLE LENDING.

It is now widely accepted that we had a large housing bubble this decade. One of the primary reasons this bubble was created was a rapid rise in unsustainable subprime and Alt A lending—loans that borrowers could not manage for long, and that would lead inexorably to foreclosure in many cases unless housing kept appreciating indefinitely into the future, further disassociated from incomes. Now that the bubble has popped, these same mortgages, now proven unsustainable, are causing massive foreclosures. Meanwhile, voluntary modifications have not restructured unsustainable loans in nearly great enough numbers to stem the tide of foreclosures.

A. Unsustainable lending was a major cause of the housing bubble.

The recent run-up in housing prices ending in 2007 resulted in an 86% real increase in U.S. housing prices. Since past corrections have tended to erase most such cyclical growth, we are likely to experience a continuing decline in housing prices. To put this in perspective, through the end of the second quarter of this year, we have seen just a 25% contraction in real terms.

Even as housing prices were rising much faster than inflation, incomes were falling behind. From 2000 through year-end 2005, median real wages grew just 1.7%, while real housing prices grew 22%.[11] The combination of real housing price in +86% nd flat or declining wages resulted in an unsustainable, and unstable, environmen : a time when long-term interest rates were historically low—meaning that the best deal for borrowers would have been fixed rate loans—originators induced borrowers to take out "innovative" variations of adjustable rate mortgages that depressed payments in the early years of the loan—and kept the bubble growing.

Only 16% of subprime mortgages being securitized were relatively straightforward fixed-rate mortgages. In contrast, 40% were 30-year ARMs, 17% were interest-only loans, 19% were 40-year ARMs, and 8% were balloon loans.[12] From 2000 to 2005, the number of subprime loans made without full documentation of income climbed from 26% of subprime -25% n 2000 to 44% in 2005,[13] while a staggering 9 out of 10 Alt-A option ARMs made ir : without full documentation.[14] Failure to escrow for taxes and insurance was yet one more ramilies were fooled thinking they could afford what were in fact unsustainable loans—occurring mainly in the subprime market[15] and contributing to higher rates of foreclosure.[16]

When Federal regulators finally proposed to require lenders to underwrite loans to the fully-indexed, fully-amortizing payment schedule that would apply after expiration of initial rates, interest-only periods, and negative amortization, the response from industry was telling. In fact, at the time, Countrywide estimated that 70% of their recent borrowers would be unable to meet this common-sense standard.[17] Industry's response represented an admission that they had been making unsustainable loans that would eventually result in unaffordable payments.

For a more robust discussion of how unsustainable lending was a major cause of the housing bubble, including several related graphs, *see* Appendix A.

B. Unsustainable lending is causing needless foreclosures now that the bubble has popped.

Housing prices have reversed course; to date, prices have fallen approximately 20%, while many expect a further 15% fall. In April of this year, foreclosures over the next five years were projected at 6.5 million.[18] Using recent MBA data, we calculate that foreclosures, across all loans, are occurring at an annualized clip of 2.3 million, with subprime loans accounting for 1.2 million of those.[19] Either projection is beyond staggering. And the subprime meltdown has now sent the entire global economy into a tailspin, despite industry experts' repeated assurances that it wouldn't.[20]

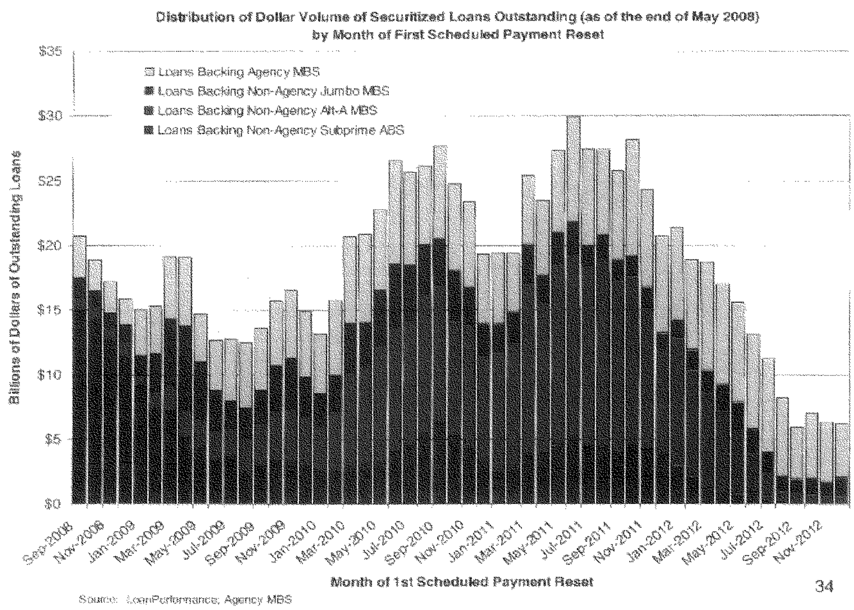
The bursting of this bubble is resulting in more foreclosures and a deeper financial crisis than it otherwise would have due to the very unsustainable mortgages that helped inflate the bubble in the first place. Millions of families now find that they cannot afford the payment upon expiration of an introductory period, nor can they refinance or sell their home because they are underwater on their mortgages and may, in addition, have been locked in by a prepayment penalty.

a. Families cannot afford the monthly payment upon expiration of an introductory period.

Introductory periods on both subprime and nontraditional loans are expiring in astounding numbers, and it's only projected to get worse. Principal loan value on securitized loans scheduled to reset in September 2008 was a little over $20 billion, including $15 billion of subprime and approximately $1 billion of Alt A. Subprime resets are scheduled to decrease steadily between now and mid-2009 and trickle to near zero by late 2010 (with a couple of upticks in mid 2010 and 2011), but since these loans are ARMs, every six months the rates on the loans will change, and resets will potentially rise if currently very low short-term indexes do.[21] And we haven't seen the tip of the Alt A iceberg. Total scheduled resets skyrocket in 2010 and 2011, reaching about $27.5 billion in late 2010 and peaking at $30 billion in mid-2011. Approximately half of that $30 billion is attributable to Alt A.

See Figure 1 on following page.

Figure 1: Resets of Securitized Loans Outstanding as of May 2008



Perhaps most reckless of all was the pervasive failure to assess ability to repay, particularly upon the inevitable increase in the original monthly payment—i.e., the payment shock. Payment shocks are created by a variety of dangerous loan structures: loans made without documenting incomes because the families simply did not afford the payment; subprime exploding ARMs where the payment increases by 30% - 40% after the second year, even if rates in the economy stay constant; interest-only loans where the payment can increase by 50% when the loan starts amortizing over a shorter remaining life; and payment option ARMs where the payment can double when it recasts at the fifth year, for lenders who require recasting at that time rather than ten years out. If they were not well underwritten at the fully indexed, fully amortizing payment when made, as many lenders failed to do, *they set the borrowers up for failure.*[22]

b. Families cannot sell or refinance because they are under water on their mortgages.

Recent reports estimate close to one in six homeowners now owe more on their mortgage than their home is worth, and almost one in three who bought their home in the last five years are in the same predicament.[23] Borrowers who are under water on their mortgage, statistically, default in much greater numbers than those who are not, largely because the safety nets of selling the house or refinancing the mortgage are no longer available when an income shock occurs through either reduced family income or higher expenses.[24] Tragically, the income shortages that ultimately lead to default are often created by the pressure on income created by the unsustainable mortgages fueling the bubble.

Further, many families that might have escaped their mortgage by refinancing before housing values became prohibitively low found themselves trapped by a prepayment penalty. Commonplace in the subprime market, a prepayment penalty on a $250,000 loan could be expected to be in the range of $4,000-$5,000—enough to prevent or discourage refinancing. Independent research has fixed the increased risk of default on subprime mortgages with prepayment penalties from 16-20% over already high baseline rates.[25]

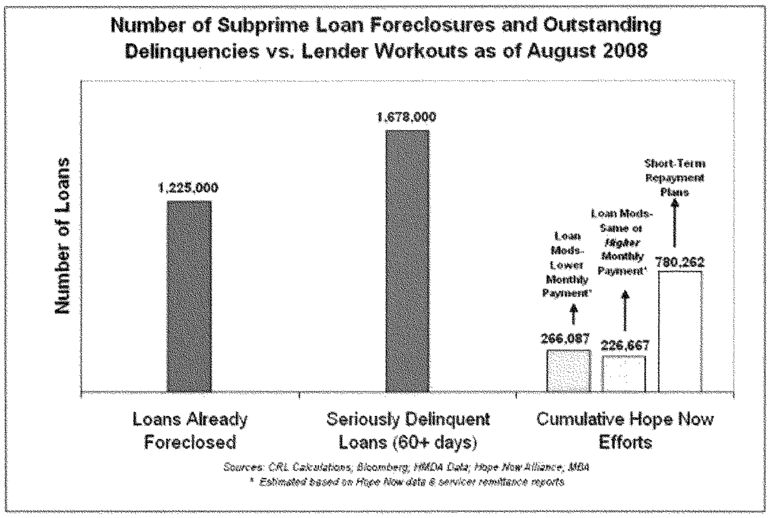
Even families who aren't holding abusive loans are finding themselves indirect victims of them. They, too, are increasingly under water on their mortgages due to the tremendous spillover effect of neighboring foreclosures. CRL's latest estimates project that 40.6 million homes neighboring subprime foreclosures will experience a property devaluation averaging $8,667 each as a result of the foreclosures, amounting to a total decline in house values and tax base from nearby foreclosures of $352 billion.[26] These families' lost equity and resulting inability to refinance or sell is contributing to the rise in foreclosures.

C. Voluntary loan modifications are not stopping the foreclosures.

Despite the loss mitigation encouragement by HOPE NOW, the federal banking agencies, and state agencies, voluntary efforts by lenders, servicers and investors have failed to stem the tide of foreclosures. Seriously delinquent loans are at a record high for both subprime and prime loans,[27] and according to most the most recent HOPE NOW data, foreclosure starts continue to outpace total loss mitigation efforts.[28]

See Figure 2 on the following page.

Figure 2: Number of Subprime Loan Foreclosures and Outstanding Delinquencies vs. Lender Workouts as of August 2008



The most recent report from the State Foreclosure Working Group (covers 13 servicers, 57% of the subprime market, and 4.6 million subprime loans) finds servicer modification progress to be "profoundly disappointing." Their data indicates that nearly eight out of ten seriously delinquent homeowners are not on track for any loss mitigation outcome, up from seven out of ten from their last report. An increasingly small number of homeowners are on track for loss mitigation, and even the homeowners who get some kind of loss mitigation actions are increasingly losing their house through a short sale or deed-in-lieu rather than keeping the home through a loan modification or workout.[29]

Neither the Housing and Economic Recovery Act of 2008 (HERA) nor the Emergency Economic Stabilization Act of 2008 (EESA) requires more than voluntary modifications. HERA creates an expanded FHA program that will help facilitate refinancing of troubled mortgages, but use of that program is voluntary and left entirely up to individual lenders and servicers. EESA, the legislation that permits the Treasury to buy troubled assets, also relies on Treasury voluntarily working with servicers to modify the loans that it buys.

There are a number of reasons why voluntary loss mitigation cannot keep up with demand. One reason is that the way servicers are compensated by lenders often creates a bias for moving forward with foreclosure rather than engaging in foreclosure prevention. As reported in *Inside B&C Lending*, "Servicers are generally dis-incented to do loan modifications because they don't get paid for them but they do get paid for foreclosures."[30] Even when a loan modification would better serve investors and homeowners, some loan servicers have an economic incentive to proceed as quickly as possible to foreclosure.

But even those servicers who want to engage in effective loss mitigation face other structural obstacles. One major obstacle is the number of homes that have more than one mortgage or lien against the home. Between one-third and one-half of the homes purchased in 2006 with subprime mortgages have second mortgages,[31] and many more homeowners have open home equity lines of credit secured by their home. The holder of the first mortgage will not generally want to provide modifications that would simply free up homeowner resources to make payments on a formerly worthless junior lien, nor to modify a loan where there is a second mortgage in default. But as Credit Suisse reports, "it is often difficult, if not impossible, to force a second-lien holder to take the pain prior to a first-lien holder when it comes to modifications," thereby dooming the effort.[32]

Another structural obstacle is posed by securitization. When servicing securitized loans, servicers are bound by the terms of the pooling and servicing agreement (PSA), which may limit what they can do by way of modification. For example, some PSAs limit the number or percentage of loans in a pool that can be modified.[33] Moreover, even if the PSA is not a problem, most modifications will disproportionately harm one set of investors (or one tranche of the security) because of how the stream of income is carved up; for example, a change in interest rate may impact different investors than a waiver of a prepayment penalty. Servicers may shy away from modifications fearing investor lawsuits.

It is also important to note the gap between rhetoric and reality about how easy it is to get a loan modification.[34] Servicers often excuse the paucity of loan modifications by claiming that their efforts to modify loans are stymied by homeowners' refusal to respond to servicers' calls and letters. While this no doubt happens, counselors report that the bigger problem is the reverse. We repeatedly hear from homeowners and housing counselors that the numerous homeowners who actively reach out to their servicers face the same problem: despite repeated calls to the servicer and many hours of effort, they cannot get anyone on the phone with the authority or ability to help. Many professional housing counselors are demoralized by the servicers' practice of incessantly bouncing the caller around from one "on hold" line to another, such that desperate homeowners never reach a live person or one with decision-making authority.

What's more, when modifications and other workouts are made, they are frequently temporary or unsustainable, leading to re-default and placing homeowners in an even worse economic position than when they started. More than a year ago, leading lenders and servicers publicly and unanimously endorsed a set of principles announced at the Homeownership Preservation Summit hosted by Chairman Dodd, which called upon servicers to modify loans to "ensure that the loan is sustainable for the life of the loan, rather than, for example, deferring the reset period."[35] Unfortunately, we now see very high rates of redefault on loan modifications, primarily because most loan modifications or workouts do not fundamentally change the unsustainable terms of the mortgage by reducing the principal or lowering the interest rate, but instead just add fees and interest to the loan balance and amortize them into the loan, add them to the end of the loan term, or provide a temporary forbearance.[36] According to Credit Suisse, when interest rates or principal are reduced, the redefault rate is less than half of those for more traditional modifications.[37]

Finally, in many cases, voluntary loan modifications or workouts are placing distressed homeowners at a further disadvantage because the servicer forces homeowners to waive all their rights in exchange, even those unrelated to the workout.

III. WHO'S TO BLAME?

A. Wall Street

1. Investors and Issuers

Wall Street's appetite for risky mortgages encouraged lax underwriting and the aggressive marketing of unaffordable loans.[38] As investors searched for ever-higher yields, Wall Street bankers thought they had found a sure-fire way to meet that demand: take subprime (risky) mortgages, bundle them into a pool, and sell off pieces of the pool—different streams of income from the mortgage loans – as securities. Ratings agencies, who were paid by the investment firms marketing these securities only when the securities were issued and sold, obligingly gave AAA ratings to the top 80% or so of the pools. Then, to bootstrap the lower-rated tranches, some of those too were repooled, sliced, and marketed magically as AAA, through collateralized debt obligations (CDOs). All of this activity took place outside the firms' balance sheets, while the size of the asset-backed securities market rose from $73 billion in 2000 to $628 in 2006.[39]

As long as housing prices continued to rise, the underlying quality of the mortgages was of no particular interest to the investment firms. Bonuses depended on short-term revenue, which trumped any incentives to worry about what would happen if the market changed. Demand from Wall Street for subprime loans was so intense that it encouraged subprime lenders to abandon reasonable qualifying standards, to forget about standard documentation requirements, and to ignore whether borrowers could actually afford the loan. As Alan Greenspan told Newsweek, "The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford. We created something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime loan market would have been very significantly less than it is in size."[40]

Wall Street investment banks became addicted to the fee income that subprime and Alt A securitizations provided. Among them, Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley took in an estimated $7.6 billion in revenues from selling and trading mortgage-backed securities in 2006—including $1.75 billion in revenues related to subprime mortgage-backed securities.[41] In addition, many became addicted to the interest income provided by highly leveraged—$30 of debt to $1 of capital—investments in these securities, investments that were fatally dependent on rolling over short-term funding.[42]

2. Rating Agencies

The investment banks and subprime lenders who gamed the system and did massive harm to homeowners and the economy could not have done so without the aid and comfort of bond rating firms. With Wall Street and federal regulators abdicating their responsibilities, the ratings industry became "the de facto watchdog over the mortgage industry."[43] As Roger Lowenstein, one of the nation's most respected financial journalists, put it in the *New York Times Magazine* this spring, Moody's, Standard & Poor's and Fitch in a practical sense set the credit standards for the loans that Wall Street could bundle into securities and, by extension, which borrowers could qualify for these loans.

But there was a problem: Because they were paid by investment banks hungry for more product to package into securities deals, the rating agencies had a strong incentive to turn a blind eye and go easy on the lenders and their Wall Street allies.[44] Rating agencies could reap $200,000 or more in fees on a single complicated mortgage-backed securities deal.[45] Moody's saw its earnings nearly triple from 2002 to 2006, largely due to high profits on structured finance deals.[46] Former SEC chair Arthur Levitt has said that the rating agencies' conflict of interest "may have distorted their judgment . . . when it came to complex structured financial products." Lowenstein has called the rating agencies "a central culprit in the mortgage bust."

Instead of requiring that lenders and investment bank use common-sense standards for verifying borrowers' ability to afford their loans, the rating agencies helped foster a Wild West mentality in which unsafe loan products and predatory sales tactics became commonplace. Investors – and the world financial markets – trusted the rating agencies because of their long history and the gloss of prudence that came with their special status in the financial system. That trust, as we now have learned, was misplaced.

B. Originators

The market Wall Street created didn't just tolerate riskier mortgages, it preferred them. Not surprisingly, originators provided what the market was paying the most for. Subprime mortgages generated much higher profit margins than prime mortgages. According to the New York Times, profit margins at Countrywide just before the bust were 2% for subprime, versus 0.82% from prime mortgages, and in 2004, subprime loans were producing gains of 3.64% versus 0.93% for prime loans.[47]

Market participants readily admit that they were motivated by the increased fees offered by Wall Street in return for riskier loans. After filing for bankruptcy, the CEO of one mortgage lender explained it this way to the New York Times, "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?"[48]

Loan originators—particularly independent mortgage brokers—specialized in steering customers to higher-rate loans than those for which they qualified, particularly minority borrowers. They also loaded up the loans with risky features, including prepayment penalties and encouraging borrowers to take out so-called "no doc" loans even when those borrowers had easy access to their W-2s.

A key driver of the upselling is a practice known as yield-spread premiums (YSPs), in which lenders pay independent brokers special bonuses if they place a customer into a higher-rate loan than that for which the customer qualifies. Generally, the maximum bonus also required the broker to sell the borrower a prepayment penalty to lock in the higher rate. Like other broker fees, the YSPs would be paid to the broker upon settlement of the loan, at which point the broker would have no further interest in the performance of that loan.[49]

This upselling resulted in a huge percentage of borrowers paying more for their loans than they should have. For example, the Wall Street Journal reported on a study that found 61% of subprime loans originated in 2006 "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms."[50] Even applicants who did not qualify for prime loans could have received sustainable, thirty-year, fixed-rate loans for—at most—half to eight tenths of a percent above the initial rate on the unsustainable exploding ARM loans they were given.[51] Indeed, many homebuyers were charged 1% more for "no-doc" loans when they had already handed over their W-2 statements or readily would have done so but for the originator's desire to make these riskier loans.[52] As a result, the typical risky adjustable rate subprime loan was more expensive than far safer thirty-year fixed-rate loans *even at the initial payment.*

Independent brokers played a particularly destructive role in the subprime market. CRL released a study earlier this year showing that brokered loans, when compared to direct lender loans, cost subprime borrowers additional interest payments ranging from $17,000 to $43,000 per $100,000 borrowed over the scheduled life of the loan. Even over a fairly typical four-year loan term, the subprime consumer pays over $5,000 more for brokered loans.[53] One explanation for this disparity is that brokers are often viewed by prospective homeowners as trusted agents shopping on their behalf for the cheapest loan. Yet brokers largely have no explicit fiduciary duty to borrowers,[54] leaving only their own economic self-interest to fulfill. Many brokers mislead borrowers or engaged in outright fraud.[55]

While much of the abuse can be traced to brokers, compensation for retail loan officers was made in a similar way. Countrywide paid both its own loan officers and brokers more for unaffordable products.[56] Broker commissions, for example, were up to 2.5% for Countrywide's poorly underwritten payment-option ARMs and 1.88% for subprime loans compared with 1.48% for standard fixed rate mortgages.[57]

The practices of IndyMac, one of the largest originators of Alt-A loans until it went defunct, demonstrate that perverse incentives drove abuse outside of the subprime market.[58] IndyMac routinely avoided including income information on their loans or pushed through loans with inflated income data, even from retirees.[59] As recently as the first quarter of 2007, only 21% of IndyMac's total loan production involved "full-doc" mortgages.[60]

Most loan originators understood that they were putting borrowers into loans that were unsustainable and that would need to be refinanced prior to reset. In 2004, the General Counsel of New Century, then the nation's second-largest subprime lender, referred to its 2/28 interest-only product and stated that: " . . . . we should not be making loans to borrowers with the expectation that the borrower will be able to refi in a couple years."[61] His warning was ignored, however, despite being a member of senior management and, according to the examiner of the company in bankruptcy, "certainly [having] influence within the company."[62]

C. Regulators

While providers of capital paid originators of loans handsomely to foist unsustainable mortgages on families, the regulators were largely asleep at the switch. The crisis we are now in is largely the result of the breakdown of this nation's regulatory system. The agencies responsible for protecting depositors, shareholders, taxpayers, borrowers and the general financial system failed. They stood by as predatory practices and dicey lending became commonplace, ravaging the mortgage market and setting off a chain reaction of financial devastation. Regulators relied on the belief that all lending is good lending, and ignored the fact that if government does not make sure that families are getting affordable loans, it cannot protect the lenders or the broader financial system either.

1. The Federal Reserve failed to effectively use its authority under HOEPA.

Fourteen years ago, Congress required the Federal Reserve Board (the Board) to prohibit mortgage lending acts and practices for all originators that are abusive, unfair or deceptive, but the Board took no action until July of this year—even though borrowers, state regulators, and advocates repeatedly raised concerns about abuses in the subprime market, and hard evidence demonstrated the destructive results of abusive practices.[63]

Eight years ago, House Banking Committee Chairman Jim Leach said to the Board:

> [C]ongress . . . passed a law which was very strong in its sense of purpose in outlawing predatory lending, in effect, and then because Congress felt that the subtleties of this were beyond Congress, we gave the Federal regulators, most specifically the Federal Reserve Board of the United States, the authority to make definitions and to move in this direction . . . . So the question becomes, if there is a problem out there, if Congress has given very strong authority to regulators and the Federal Reserve, or regulators, is the Federal Reserve, our regulators, is the Federal Reserve AWOL?[64]

At that time, we also urged the Board to use its unfair and deceptive practices authority under HOEPA to prohibit abusive practices such as prepayment penalties on mortgages with interest rates greater than conventional rates.[65] While the Fed was failing to act, dozens of states passed their own regulations to address abusive practices.[66]

As noted earlier, in July of this year, the Board finally exercised its authority to prohibit unfair and deceptive practices by issuing a strong rule with respect to subprime loans. We commend Chairman Bernanke and the Board for this big step forward while noting that had these rules been issued just three years earlier, countless foreclosures could have been prevented. And still left for another day are broker incentives to provide worse loans than borrowers qualify for through yield-spread premiums and abusive practices on nontraditional loans.

2. Regulators failed to regulate investment banks and credit default swaps.

In 2004, the Securities and Exchange Commission (SEC) exempted the brokerage units of the five largest investment banks from its leverage requirements.[67] The freed-up capital allowed the banks' parent companies to invest in mortgage-backed securities, credit default swaps, and other exotic mortgage-related products. Leverage ratios soared. In exchange for the relaxed regulation, the investment banks offered to allow the SEC to examine their books, creating a system of voluntary oversight for five institutions whose assets in 2007 totaled $4 trillion.

Unfortunately, as SEC Chairman Christopher Cox has recently admitted, "The last six months have made it abundantly clear that voluntary regulation does not work."[68] What's more, the SEC did not use the authority it did have. A recent SEC Inspector General report notes that the SEC's division of trading and markets "became aware of numerous potential red flags prior to Bear Stearns's collapse, regarding its concentration of mortgage securities, high leverage, shortcomings of risk management in mortgage-backed securities and lack of compliance with the spirit of certain [capital standards]," but it "did not take actions to limit these risk factors."[69]

Failure to regulate credit default swaps was a key factor enabling the subprime securities market to grow as large as it did.[70] Instead of labeling these transactions as insurance— which would have required the retention of sufficient capital to cover defaults—regulators allowed them to be characterized as over-the-counter and unregulated swaps. Moreover, the $60 trillion credit default swaps market[71] encouraged speculation, since investors could purchase the insurance without purchasing the security. When housing prices fell and rendered the securities worthless, the insurers—like AIG—lacked sufficient capital, by a long shot, to cover all the defaults.

3. The OCC was focused on preempting stronger state laws.

The Office of the Comptroller of the Currency (OCC) also played a key role in the mortgage meltdown, both by actively blocking state consumer protection laws through the expansion federal preemption, and by simultaneously failing to adequately monitor the nationally-chartered lending institutions under its purview.

Since the late 1990s when anti-predatory lending laws were enacted by several states to provide substantive protections for consumers and place responsible checks on mortgage lending, the OCC worked to expand the reach of its powers and preempt state laws.[72] The laws that the OCC worked to displace were not only designed to protect homeowners, but to preserve a safe, well-functioning market.

Several actions taken by the OCC under former Comptroller John D. Hawke, Jr. are particularly noteworthy for their likely consequences. First, in 2002, Georgia passed comprehensive mortgage reform legislation, which included assignee liability. Upon request of National City Bank and its subsidiaries, including subprime lender First Franklin Financial, the OCC pronounced the Georgia law preempted in its entirety, and followed by proposing expansive new preemption rules.[73] Bolstered by the OCC action, subsequent efforts led to the gutting of the Georgia law. According to former head of the Office of Thrift Supervision, Ellen Seidman, had the law remained on the books, it could have served as a model for other states, and may have reversed the course or reckless lending earlier in the game.[74]

In 2003, State Attorneys General concerned about the rise of increasingly risky and abusive loans met with Hawke to request more leeway for the states to confront the problem.[75] Comptroller Hawke reportedly stood his ground on preemption, however. As the former North Carolina Attorney General saw it, "The OCC 'took 50 sheriffs off the job during the time the mortgage lending industry was becoming the Wild West.'"[76] Repeatedly, state officials who sought to rein in reckless lending practices "were thwarted in many cases by Washington officials hostile to regulation and a financial industry adept at exploiting this ideology."[77]

While the OCC is quick to place the blame on states for failing to regulate the entities under state control, the OCC's stringent preemption policies had a double whammy effect. Not only did they block strong regulation of federally-chartered entities, the immunity of federal entities prompted arguments from state-chartered entities that strong state reforms would create an "uneven playing field" in which they could not compete. These arguments served to chill action by state policymakers, and the result was a level playing field—on a field with no rules.

Unfortunately, while the OCC thwarted state efforts, it also ignored evidence of predatory lending within national banks and their affiliates and subsidiaries, simply repeating the mantra that there was no predatory lending in the national banks.[78] Only one of the 495 OCC enforcement actions against national banks from 2000 through 2006 involved subprime mortgage lending.[79]

As early as 2003, however, CRL highlighted to the OCC the evidence and/or allegations of predatory lending among national banks and their subsidiaries such as Guaranty National Bank of Tallahassee,[80] Wells Fargo, and First Franklin.[81] As we witness the record-breaking losses among the national banks from their exposure to subprime and other risky mortgages, there is no longer any question that federally-chartered banks and their lending arms engaged in risky and often predatory lending. Merrill Lynch, which purchased First Franklin from National City, had to shut the unit down after its $1.3 billion purchase became essentially worthless, and has seen total losses exceeding $50 billion.[82] Large national banks have reported combined losses of $100 billion from their subprime exposure.[83]

We commend Comptroller Dugan and the OCC for helping to lead the other federal agencies in issuing the Interagency Guidance on Nontraditional Mortgage Product Risks in late 2006 and the Statement on Subprime Mortgage Lending in June 2007. Such guidance, however, underscores the failed oversight by the OCC prior to this time that I just described. As one example, Countrywide booked $161 billion in payment option ARM loans while it was under the watch of the OCC, but ***86% of those loans could not meet the interagency guidelines***.[84] Some predict that given the lack of underwriting and risky features, as many as 45-50% of POARM loans that were current at recast, will eventually end in default.[85]

The unfortunate truth is that if the OCC had not spent more time performing its duties of oversight rather than attempting to make their charter the most appealing, the OCC could have played an important role in averting this crisis.

4. The OTS utterly failed in its oversight responsibilities.

All federal banking regulatory agencies must share in the blame for the mortgage debacle, but the Office of Thrift Supervision stands out for its record of failure. The collapse of three institutions under OTS's watch—NetBank, IndyMac and Washington Mutual—constitute case studies of regulatory ineptitude.

An inspector general's report in the wake of the September 2007 failure of NetBank concluded that OTS ignored had clear warning signs about the bank's risky lending.[86] The Inspector General found OTS "did not react in a timely and forceful manner" to "repeated indications of problems in NetBank's operations"—problems that had been evident for years in OTS examinations.[87]

Yet NetBank's failure was simply a prelude to the downfalls of IndyMac and Washington Mutual. Never before in American history have two banks so large failed within months of each other. IndyMac's failure is the fourth largest bank failure in American history. WaMu's collapse was the largest ever.[88] OTS failed to take effective action to halt the unsafe and unfair lending practices that eventually doomed both. And even as it became clear that these two banks' loan performance and financial returns were rapidly taking a turn for the worse, OTS failed to act aggressively to alleviate the damage. In fact, OTS prevented FDIC from taking timely action by declining to put the two banks on the government's list of trouble banks until just before they went under—far too late to make any difference.

Had OTS looked with a skeptical eye, it wouldn't have been hard for the agency to find signs IndyMac was engaging in high-risk activities. This was made clear by the large percentage of poorly underwritten mortgage products that made up IndyMac's loan portfolio—low- and no-documentation loans that required little or no verification as to borrowers' ability to repay. The result was a growing list of consumers stuck in predatory loans that endangered their homes.

IndyMac's customers included people like Simeon Ferguson, an 86-year-old retired chef living in Brooklyn, N.Y. Mr. Ferguson was suffering from dementia at the time he got a loan from IndyMac. A lawsuit filed on Mr. Ferguson's behalf claims a mortgage broker used the false promise of a 1% interest loan to steer Mr. Ferguson into an IndyMac "stated income" loan program for retirees. IndyMac made no effort to verify retirees' income, attempting to duck accountability "by deliberately remaining ignorant of the borrower's ability to pay the mortgage," the lawsuit says. IndyMac's instructions for preparing the mortgage application required that "the file must not contain any documents that reference income or assets."[89]

The damage to borrowers and other citizens would have been reduced if OTS had forced IndyMac to pull back as the housing and mortgage markets slowed in 2006. Instead, IndyMac continued to push aggressively for more growth, increasing its loan volume by some 50% in 2006, during a year when overall industry volume fell slightly. As a growing number of loans went bad, OTS failed to identify the danger that IndyMac faced—despite the fact that measures of the bank's financial health first showed significant signs of trouble in mid-2007, and indicated accelerating deterioration in the fall of 2007.[90]

In the end, IndyMac's demise cost thousands of bank employees their jobs. Large numbers of customers with uninsured deposits will get only a fraction of their savings back. And the failure is expected to cost the federal Deposit Insurance Fund nearly $9 billion.[91]

It appears the story was much the same with Washington Mutual as it was with IndyMac. WaMu grew its volume of subprime lending from $19.9 billion in 2003 to $36 billion in 2005. One example of WaMu's less-than-sterling lending record has been highlighted by Mike Shedlock, an economic analyst who's been tracking a bundle of more than $500 million in loans that WaMu packaged into a mortgage-backed securities pool in May 2007. The borrowers didn't appear to be bad risks; their average FICO score topped 700, indicating they had solid credit histories. But barely 10% of the loans in the pool were made with full documentation of borrowers' ability to repay. One year into its life, 31% of the pool was at least 60 days late and, of this percentage, roughly 23% was already in foreclosure or in repossession.[92]

An ABC News investigation cites dozens of former employees who say WaMu's management brushed aside and in some cases fired risk management gatekeepers who warned that the bank was steering down a dangerous path. "Everything was refocused on loan volume, loan volume, loan volume," a former senior risk manager told ABC, adding that on several occasions higher ups pressured him to upgrade his risk assessment in order to make a loan deal go through. Another former employee said that mortgage underwriters were instructed not to question whether or not a loan should be approved, but to simply check whether certain lending procedures had been followed.[93]

State authorities in New York, meanwhile, are pressing a case that accuses WaMu of systematic fraud in its appraisal process. In November 2007, New York state Attorney General Andrew Cuomo sued one of the nation's largest appraisal companies, claiming that the firm had caved into the pressure from WaMu to use only appraisers who were willing to "bring in the values" that WaMu's loan sales staff demanded.[94] Cuomo said that WaMu had "strong-armed" the appraisal firm into allowing the bank to hand-pick appraisers willing to inflate home values and help questionable loans go through, as part of "a system designed to rip off homeowners and investors alike."[95] In all, the appraisal firm did more than 260,000 appraisals for WaMu between the spring of 2006 and the fall of 2007, earning $50 million in fees.

In short, WaMu and IndyMac were not guileless victims of financial hurricanes they had no control over, and the OTS had readily available information about what was going on, yet declined to intervene.

As we noted in above, we believe OTS should be merged into a unitary regulator that has a much stronger focus on consumer protection and bank safety.

5. HUD should not have provided affordable housing goals credit for Fannie Mae's and Freddie Mac's purchase of subprime securities.

In order to ensure that Fannie Mae and Freddie Mac serve the interests of families of modest means, Congress delegated to HUD the authority to set affordable housing goals for the GSEs. While both GSEs adopted standards on loans they would purchase, these standards were not applied to securities in which they invested. The GSEs purchased securities of loans that violated the standards until 2007 when Freddie Mac first voluntarily agreed to stop[96] and the Office of Federal Housing Enterprise Oversight (OFHEO) later ordered both GSEs to stop.[97]

Back in 2000, we started arguing that Fannie and Freddie should not receive goals credit for investing in securities backed by abusive loans.[98] Numerous other groups argued the same point in comments to HUD during the 2000 and 2004 goals setting processes.[99] However, HUD failed to open the door to consider what abusive loans should not be permitted to count under the goals or permitted to be purchased at all.

6. Federal regulators' failure is especially clear in light of States' efforts.

In recent years, when the federal government failed to act, a number of states moved forward to pass laws that address abusive practices. The leadership shown by states helped to encourage the adoption of best practices by responsible lenders and leaders in the mortgage industry. Research assessing these laws has shown them to be successful in cutting excessive costs for consumers without hindering access to credit.[100] And other states benefited as well. Spearheaded by active states such as North Carolina and Iowa (among others), the states Attorneys General pursued enforcement actions and settlements against some of the larger institutions that employed widespread abusive practices. These settlements held bad actors accountable for their actions, brought relief to borrowers and influenced the marketplace nationwide.

States could not do the job alone, however. Industry vigorously opposed state efforts and thwarted many of them. In fact, even good state bills did not prevent foreclosure crises in those states. A major problem was that state bills often did not capture the largest mortgage finance companies making many of the most irresponsible loans. The Board, on the other hand, had the authority to reach *all* market actors and could *extend* common sense practices and model protections provided by many states on a macro basis. Sadly, a popular argument that kept some states from enacting more stringent laws was only available because of lax federal regulations: that protective states laws would place state chartered lenders at a competitive disadvantage, while federally chartered entities could operate under more relaxed federal standards.

IV. WHAT DIDN'T CAUSE THE CRISIS

A. COMMUNITY REINVESTMENT ACT

In an attempt to divert attention away from the destructive lending practices and lack of government supervision that fueled the credit crisis, some are trying to place the blame for it on the Community Reinvestment Act (CRA). They argue that CRA forced lenders to make risky loans to low- and moderate-income families and to communities of color.

Nothing could be farther from the truth. Lenders made riskier, higher interest rate loans because they were the most profitable ones in short-term, generating huge fees and bonuses for participants up and down the chain—brokers, lenders, securitizers and investors. On their list of priorities, sustainability fell a distant second to profitability.

CRA, on the other hand, has led to affordable, sustainable loans in underserved communities. Consider these facts:

- CRA was in effect long before the subprime market existed. CRA was passed in 1977 to correct the longstanding problem of redlining – the lack of lending in low and moderate income communities and in communities of color. CRA has been on the books for three decades, while the lending practices that created this crisis didn't exist until the past five years.[101]

- Most subprime lenders weren't covered under CRA. The predominant players in the subprime market—mortgage brokers, mortgage companies and the Wall Street investment banks that provided the financing—aren't covered under CRA.[102] In fact, in 2004 and 2005, at the height of the subprime boom, the two biggest subprime lenders alone, Ameriquest and New Century, accounted for approximately 22% of all subprime loan volume.[103] They drove the market; all others followed; both were non-bank lenders not covered by CRA. Finance company affiliates of major banks participated heavily in subprime lending, but are only included in CRA to the extent their bank parents choose them to be. In fact, many banks shifted the most risky lending—the loans at the root cause of this current crisis—to affiliates to escape CRA requirements and regulatory oversight.

- CRA-covered banks made safer loans than institutions not covered under CRA. A recent study found that CRA-covered banks were less likely than other lenders to make a high-cost loan; the average APR on their high cost loans were lower than those originated by non-covered lenders; and they were more likely than other lenders to retain originated loans in their portfolio (indicating that they had the incentive to make affordable loans).[104] In addition, foreclosure rates were lower in Metropolitan Statistical Areas with greater concentrations of bank branches.[105]

- Wall Street created the demand for riskier loans. As Newsweek stated, "Investment banks created a demand for subprime loans . . . . and made subprime loans for the same reason they made other loans: They could get paid for making the loans, for turning them into securities, and for trading them—frequently using borrowed capital", not because of CRA.[106]

- The majority of subprime loans went to white borrowers. While it is true that African-American and Latino families disproportionately received ruinous subprime loans, the majority of total loans were made to non-Latino white families. According to data from the Home Mortgage Disclosure Act (HMDA) from 2005-2007, 58% of higher-cost loans went to white borrowers, with 18% to African-American borrowers and Latino borrowers each.

As *Newsweek* aptly concluded, "Lending money to poor people doesn't make you poor. Lending money poorly to rich people does."[107] The answer to this financial crisis not to cut off access to credit in underserved communities. Homeownership still represents the best way for low and moderate income families to build wealth—we shouldn't abandon that goal because of subprime lenders' bad decisions.

B. HOMEOWNERS WHO ARE NOW ON THE VERGE OF LOSING THEIR HOMES

During the height of subprime lending, industry often defended questionable lending practices by saying that the subprime market was a key part of building homeownership. Since the market has fallen, the story line has shifted, and now one of the myths that has been widely circulated is that typical recipients of subprime loans were greedy, low-income and minority borrowers, who foolishly took out home loans they could ill afford to buy expensive homes. However, the facts belie this stereotype, and show that too often lenders steered customers to loans described as "unfair" and "deceptive" by Federal Reserve Chairman Ben Bernanke. In fact, when issuing new lending rules in July 2008, the Fed's preamble to the rules included this comment:

> "Consumers in the subprime market face serious constraints on their ability to protect themselves from abusive or unaffordable loans, even with the best disclosures; originators themselves may at times lack sufficient market incentives to ensure loans they originate are affordable; and regulators face limits on their ability to oversee a fragmented subprime market."[108]

While subprime lenders claimed that these risky loans made homeownership a reality for borrowers who would not otherwise qualify for conventional loans, the *Wall Street Journal* has reported a different story. According to the *Journal*, the majority of borrowers at the height of the subprime lending in 2005 and 2006 could have qualified for lower-cost conventional mortgages. By 2006, 61% of subprime mortgages went to borrowers with credit that would have qualified them for conventional loans.[109] Further, those who needed subprime loans often qualified for thirty-year fixed rate loans but were steered into exploding ARMs at higher rates with worse terms.

In addition, 90% of subprime mortgages made were to borrowers who already owned their own homes.[110] Sixty percent were refinances, and 30% were for families who were moving from one home to another.[111] These dangerous loans in fact caused a net reduction in homeownership.

Although some like to portray distressed homeowners as people who took out loans to cover sprawling McMansions, data collected under the Home Mortgage Disclosure Act show this isn't the case: The most recent information collected under the Home Mortgage Disclosure Act shows that the average subprime loan amount was only $205,700.[112]

Lenders are professional risk managers, and will always know more than borrowers. Yet John Robbins, the former Chairman of the Mortgage Bankers Association, described the deceptive loans made by his industry as "extremely risky" and the lenders who made them as more focused on money and commissions rather than customers.[113]

As we consider how this market has operated in recent years, it is important to remember the impact on ordinary, hard-working people all over the country. As one illustration, consider the plight of Candace Weaver, an eighth grade teacher in North Carolina. Mrs. Weaver refinanced her mortgage in 2005 to pay bills that had accumulated after her husband had a heart attack and was out of work. She received an adjustable-rate mortgage that started at 8.85% but then after two years went to 11.375%, and was set to go as high as 15.85%. Mrs. Weaver was never offered a fixed-rate loan, and she didn't understand her rate could change.

Six months after getting the mortgage, Mrs. Weaver was diagnosed with kidney cancer. Even before she had surgery, she called her loan servicer to try to work something out because she anticipated having a hard time keeping up payments. However, the servicer refused to help until she was actually in default, and then they offered her an expensive plan to avert foreclosure. Mrs. Weaver managed to pay $7,000 over six weeks, but she fell behind again, and the foreclosure proceedings that had been put on hold resumed. This stress, in addition to her health problems, has placed an enormous strain on the Weaver family. The upshot is that an abusive loan has severely undermined the Weavers' financial security, and may ultimately rob them of their home.

C. FANNIE MAE and FREDDIE MAC

The current crisis has laid bare the dangers of our government's failure to rein in industry's excesses and safeguard against inappropriate lending practices. In response, opponents of efforts to impose such safeguards on industry have begun a high profile campaign to insist that such safeguards are not needed for the loan originators who made the blatantly unsustainable loans, the Wall Street firms who bought the loans and securitized them, or the investors who purchased the securities. Instead, they claim that the blame lies with Fannie Mae and Freddie Mac because the GSEs also purchased some of these securities. According to this claim, Fannie Mae and Freddie Mac alone should have been subject to greater regulation that precluded them from buying these securities, but the other parties that made, securitized and invested in these loans should be left alone. The claim is further made that it was government mandates that required Fannie and Freddie to purchase loans to low-income families that caused large taxpayer losses.

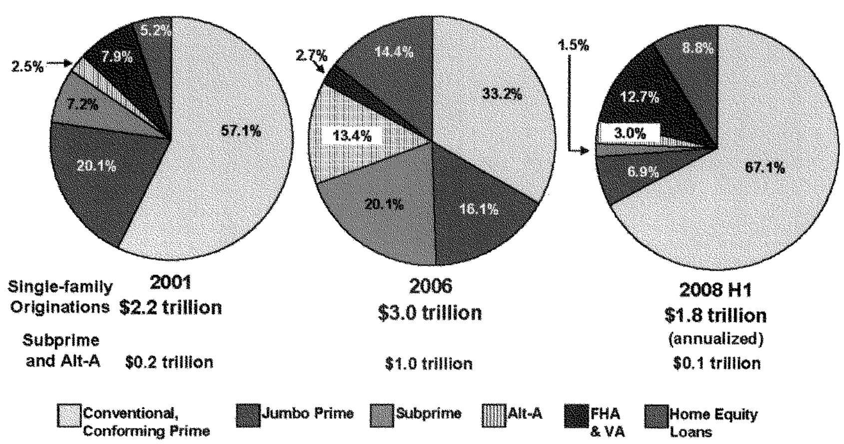
Fannie Mae and Freddie Mac publish lending guidelines that set minimum standards for the loans they buy. The loans that drove the present crisis, subprime loans, did not meet these standards, and the GSEs thus did not buy them directly.[114] For this reason, the purchase and securitization of these substandard loans was done exclusively by Wall Street firms.

Fannie Mae and Freddie Mac did, however, purchase a substantial number of these "private label" mortgage backed securities (that is, securities created by Wall Street), particularly early in subprime's development; we have severely criticized this fact, including in testimony to this Committee.[115] Instead of denouncing these inappropriate Wall Street practices, the GSEs joined the bandwagon for these investments. To its credit, in February 2007, Freddie Mac suspended its purchase of mortgage backed securities based on loans that did not consider the borrower's ability to repay based on the higher expected rate that would occur after two years of a subprime hybrid ARM.[116]

Fannie Mae and Freddie Mac also eventually followed Wall Street into the purchase of Alt-A loans, typically without documentation of borrower income. These poorly underwritten, risky loans have produced substantial losses for the GSEs, as they have for Wall Street, although GSE Alt A loans have performed much better than privately securitized loans.

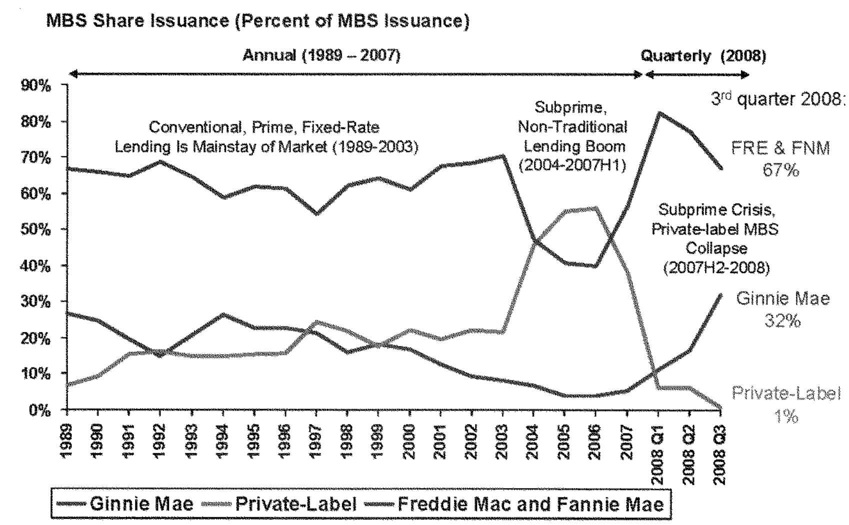
Nevertheless, it would be wrong to assign the GSEs the leading role in the subprime crisis. First, the GSEs' role in the mortgage market diminished substantially as subprime lending rose. As of 2001, Fannie Mae and Freddie Mac funded almost two-thirds of home mortgage loans across the United States. These were loans that Fannie Mae and Freddie Mac purchased directly from originators who met the GSEs' guidelines and either held on their balance sheets or securitized and sold to investors. In contrast, subprime loans accounted for just 7% of the market. This began to change around 2003, when the GSEs were largely displaced by private issuers who were beginning to introduce new, riskier loan products into the market.[117] In early 2004, private-issue MBS surpassed the GSE issuances of all loans, and by early 2006, Fannie and Freddie's market share of new issuances had *dropped* to one-third of the total. At the same time that the role of the GSEs was declining, the percentage of loans in the mortgage market that was subprime almost *tripled*, as shown in Figures 3 and 4 below.[118]

Figure 3: Subprime and Alt-A Volume Quintupled 2001 to 2006, Then Fell in 2007 to 2008



Source: Frank E. Nothaft, Chief Economist, Freddie Mac, Presentation prepared for Milken Institute's Financial Innovations Lab on Housing: Beyond the Crisis, Oct. 7, 2008, p. 1 (citing Inside Mortgage Finance, by dollar amount).

Figure 4: MBS Share Issuance (Percent of MBS Issuance) 1998-present



Source: Frank E. Nothaft, Chief Economist, Freddie Mac, Presentation prepared for Milken Institute's Financial Innovations Lab on Housing: Beyond the Crisis, Oct. 7, 2008, p. 1 (citing Inside Mortgage Finance, by dollar amount).

Second, the GSEs' purchase of private label subprime securities was dwarfed by the purchases made by hedge funds, Wall Street firms and other private investors. During the first nine months of 2006, the GSEs bought 25% of the private label subprime mortgage-backed securities sold, and their purchases were limited to the AAA tranches.[119] Other investors purchased the other 75%, including 100% of the subordinate securities. It is worth noting too that the AAA tranches were the least risky and therefore most readily marketable securities. Thus, the GSEs were not creating a market for unsellable securities; to the contrary: had the GSEs not bought them, numerous other investors were eager to do so.

Similarly insupportable is the claim that the GSEs' financial woes resulted from the GSEs' HUD-mandated affordable housing goals. It is true that Fannie Mae and Freddie Mac received affordable housing goals credit for the purchase of subprime securities, although it is likely that higher yields were the major motivation. But subprime loans are not the cause of the GSEs' financial problems. Currently Freddie Mac has $85 billion and Fannie Mae $28 billion of subprime securities on their balance sheets.[120] These securities are subordinated by approximately 20%, which means that the GSEs will not lose principal unless approximately 40% of the borrowers lose their homes to foreclosure. While this may occur, their losses will be relatively modest due to the senior position they hold. Freddie Mac has impaired this portfolio by $500 million.[121] Fannie Mae holds $8 billion of whole subprime loans that it purchased, but these have caused just 2.2% of its second quarter losses.[122]

The source of both GSEs' losses, and the reason they are no longer independent, are not these subprime loans to low-wealth borrowers, but rather the Alt A loans that the GSEs purchased that were made to relatively wealthier borrowers. Critiques of Fannie and Freddie tend to conflate the earlier subprime securities purchases and their later jump into purchasing higher-income loans where lenders did not document borrower income.

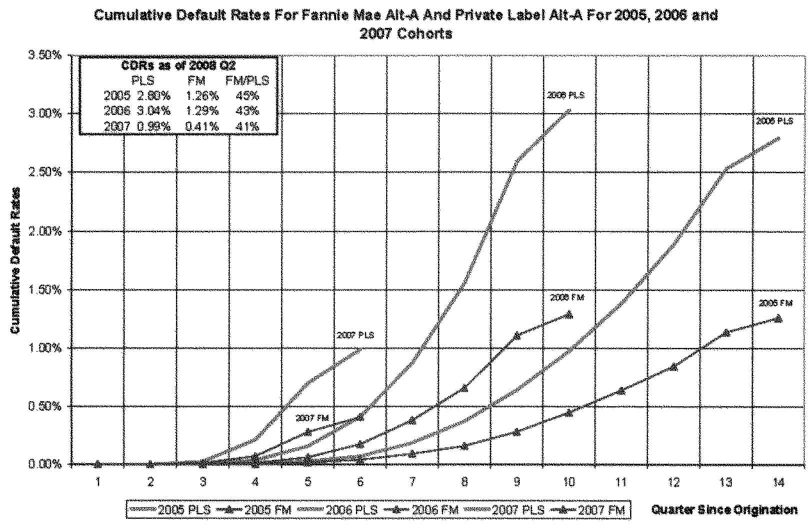
The Alt A epidemic was in full flower by the time that the GSE's got into the act; see Figure 3 above. In 2004, Angelo Mozilo, then chief executive at Countrywide, reportedly demanded that Fannie Mae buy the lender's riskier loans, or else they couldn't purchase its less risky loans.[123] "You're becoming irrelevant. You need us more than we need you, and if you don't take these loans, you'll find you can lose much more," Mozilo reportedly said, and at the time, his assertion would have been hard to dispute.[124] Fannie Mae and Freddie Mac started buying Alt A loans in significant numbers. From 2005 to 2007, Fannie bought three times as many loans without the usual documentation of income or savings as it had in all earlier years combined.[125]

By the middle of this year, Alt A loans account for roughly 10% of Fannie and Freddie's risk exposure, but a whopping 50% of their combined losses.[126] Losses on Freddie Mac's Alt A loans have accounted for 79% of the increase in total credit losses (from $528 million to $810 million) between the first and second quarters of 2008.[127]

While the move into Alt A mortgages was ill advised, it was not driven by affordable housing goals pressure. Alt A mortgages are generally high balance, higher income, high credit score loans that are classified as Alt A because they do not document income or assets.[128] Given their income characteristics, they actually *dilute* the GSEs' affordable housing ratios, yet these are the loans that are causing the GSEs' losses.

Moreover, as ill advised as the GSEs' Alt A exposure was, the Alt A activities of Wall Street were even worse. As shown in Figures 5 and 6 below, the credit characteristics of Wall Street's private label Alt A mortgage backed securities were far riskier than those of Fannie Mae's Alt A loans, and, for this reason, Wall Street's losses on Alt A loans were much higher.

Figures 5 and 6: Fannie Mae Alt A Loans Versus Loans Underlying Private-Label Alt A Securities



Note: The last data point on each curve is as of April 30, 2008. Private label security data is from Loan Performance.

Fannie Mae Alt-A Loans Versus Private Label Security Conforming Alt-A		
	Fannie Mae Alt-A As of April 2008	PLS Market Alt-A Outstanding loans backing non-agency Conforming Alt-A MBS as of April 2008
FICO	719	709
OLTV	73%	76%
CLTV at Origination	77%	82%
Product Type		
Fixed Rate	71%	43%
Adjustable Rate	29%	57%
Interest Only	21%	26%
Negatively Amorti:	3%	25%
Investor	17%	21%

Source: Fannie Mae Q2 10-Q Investor Summary (Aug. 8, 2008).[129]

The final point to make regarding the GSEs is that although they contributed to the subprime market, and they made wrongheaded investments in loans that did not document income, they were a lifeline for the economy when the Wall Street-driven asset-backed securities market dried up in 2007 because of excessive mortgage-related losses; see Figure 4 above. And as demonstrated in Figure 3 above, by 2008, the GSEs and FHA provided liquidity for virtually all conforming sized loans in the country. If the GSEs had not stepped in when they did, the credit crunch that we are facing would be infinitely worse, as would the current recession. Further, as we can attest through our long-standing partnership with Fannie Mae, their investment in sustainable loans in low-income and low-wealth communities has substantially improved the lives of hundreds of thousands of American families.

Unfortunately, those who have been calling for greater regulation of the GSEs have not been calling for the reigning in of abusive lending practices, or the securitization practices that enable them. This is because for the most part, these advocates are themselves frequently industry players who want a bigger share of this market for themselves. For this reason, they urge the abolition of these practices for the GSEs alone, while urging that the rest of the industry have free reign to continue them. Other advocates of abolishing these practices by the GSEs are those rightfully concerned about the risk to taxpayer dollars being taken by the GSEs. While reining them in would have saved taxpayer losses (although none have occurred to date, and we can hope they do not), which is very important, it would not have averted the financial crisis; it would simply have distributed more of the losses to private firms. As we now see, these Wall Street firms' losses can become the taxpayers' problem as well.

In any event, all homeowners pay the price for the irresponsible lending practices of recent years. To reign these in for the GSEs, while ignoring the greater and more widespread abuses of the rest of the market, would do nothing to prevent similar crises from occurring again.

CONCLUSION

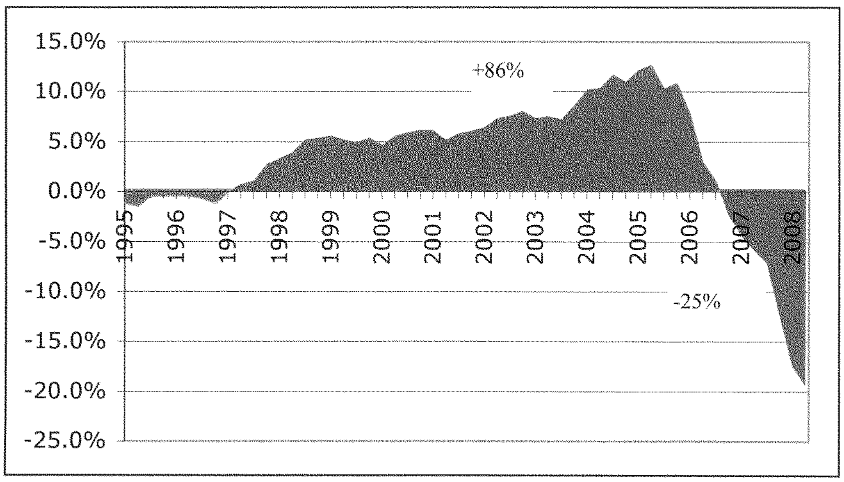
Today's financial crisis is a monument to destructive lending practices—bad lending that never before has been practiced on such a large scale, and with so little oversight. Unfortunately, the entire country is paying the price. There is no single solution to the challenges facing us today, but any effective policies must seek to maximize the number of people who stay in their homes. In particular, Congress should lift the ban on judicial restructuring of loans on primary residences, Treasury should ramp up its efforts to do FDIC-like streamlined modifications, Congress should merge OTS into OCC, the Federal Reserve should extend its HOEPA rules and Congress should pass the Dodd anti-predatory lending bill.

APPENDIX A

UNSUSTAINABLE LENDING WAS A MAJOR CAUSE OF THE HOUSING BUBBLE.

The recent run-up in housing prices ending in 2007 resulted in an 86% real increase in U.S. housing prices. Past corrections have tended to erase most such cyclical growth. To put this in perspective, through the end of the second quarter of 2008, we have seen just a 25% contraction in real terms.

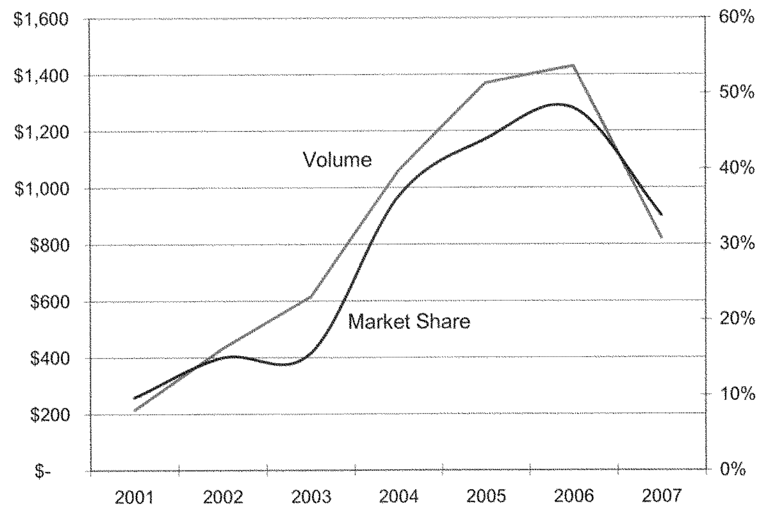
Figure 7: Inflation-Adjusted Annual Change in U.S. Housing Prices with Cyclical Totals



Sources: Standard & Poor's S&P Case-Shiller Home Price Indices, BLS

Even as housing prices were rising much faster than inflation, incomes were falling behind. From 2000 through year-end 2005, median real wages grew just 1.7%, while real housing prices grew 22%.[130] The combination of real housing price increases and flat or declining wages resulted in an unsustainable—and unstable—environment. Amounts borrowed grew dramatically relative to incomes over recent years; the sharp increase from 2001 through the end of the period coincides with dramatic increase in subprime and Alt-A lending. Figure 8 shows that by 2006, subprime, Alt-A, and home equity lending more generally had reached a near-majority (48%) of total volume loaned that year.

Figure 8: Total Subprime, Alt-A, and Home Equity Volume in Billions and Share of Mortgage Origination Volume, by Year

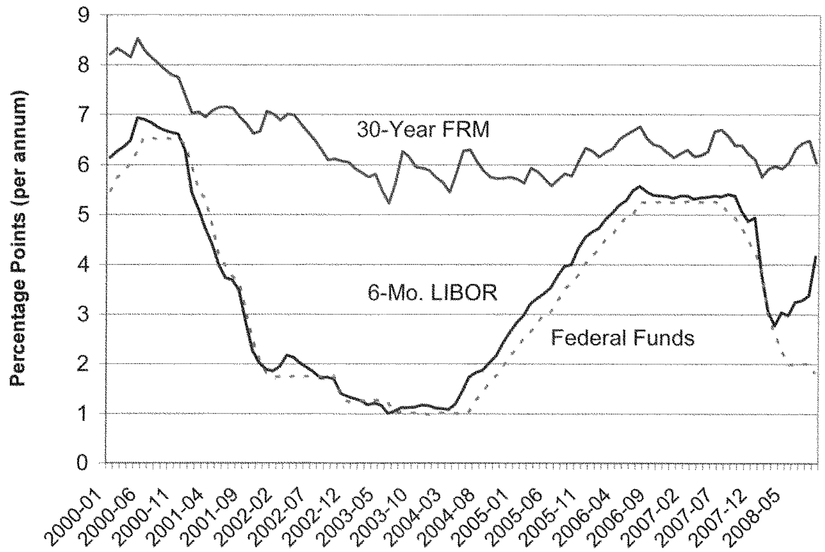


Source: IMF Publications[131]

At a time when long-term interest rates were historically low—meaning that the best deal for borrowers would have been fixed rate loans—originators induced borrowers to take out "innovative" variations of adjustable rate mortgages that depressed payments in the early years of the loan and induced payment shock later on.

Figure 9 displays the rates on 30-year fixed-rate mortgages and the LIBOR index commonly used to price subprime adjustable-rate mortgages and the Federal funds rate, all of which reached 30-year lows in the period covered. These low rates translated into smaller monthly payments and obscured the true cost of mortgages for many families, particularly with ARMs.

Figure 9: Interest Rates Dip to Historic Lows



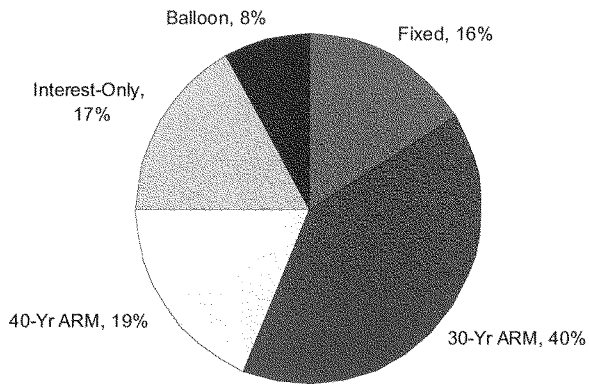
The unsustainable nature of loans was masked by these mortgage "innovations" that obscured the true cost of mortgage credit and eschewed time-tested underwriting standards to approve as many loans as possible—introductory rates bound to rise, interest-only loans and payment option ARMs for families for whom this product was not appropriate; low and no doc loans; and a departure from escrow for taxes and insurance.

a. "Innovative" loan features: "teaser" rate ARMs, interest-only loans, payment option ARMs.

A switch to mortgages with introductory rates that were bound to rise allowed families to defer repayment of principal or to pay less than the amount of interest owed on the loan, while these products were not suitable for families who could not afford the fully amortizing rate. Though introductory rates expire, families that raised such concerns were routinely counseled that they would be able to refinance or sell their home later. Even for those whose misgivings continued, the flawed perception that the mortgage market was heavily regulated and the pressure to buy a home to avoid the threat that homeownership would become permanently unaffordable were powerful salves. In fact, the strategy of financing mortgages with unaffordable mortgages worked for at least a few years as rapidly increasing property values supported subsequent refinancing into loans with a new introductory rate. However, embedded in each of these mortgages was a rate or payment waiting to explode when property values ceased their upward march.

By 2006, Figure 10 shows that just 16% of subprime mortgages being securitized were relatively straightforward fixed-rate mortgages. In contrast, 40% were 30-year ARMs, 17% were interest-only loans, 19% were 40-year ARMs, and 8% were balloon loans. These factors permitted more families for whom the mortgages were not ultimately sustainable to qualify.

Figure 10: Traits of Securitized Subprime Mortgages from 2006



Source: Chaudhary[132]

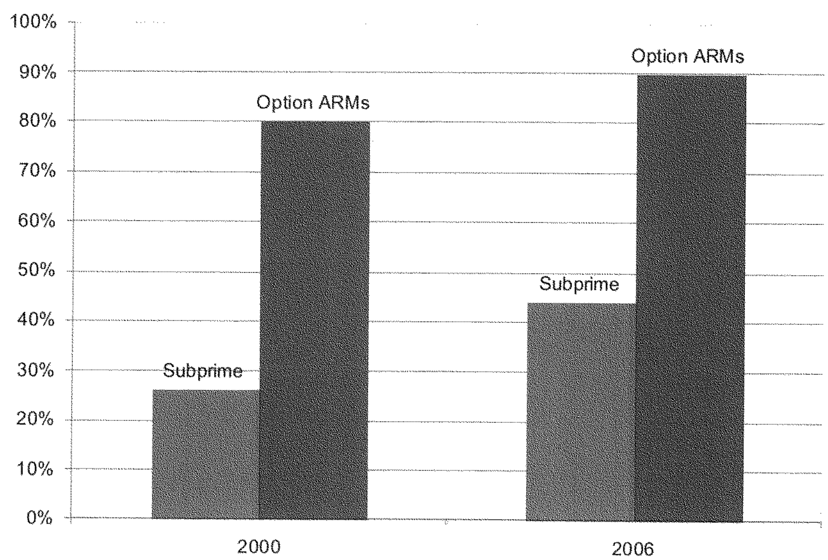
The shift to adjustable-rate mortgages among weaker borrowers was particularly unfortunate: The difference between a fixed-rate and an adjustable subprime mortgage at origination was commonly half to eight tenths of a percentage point.[133] In fact, given the very high margin over the short term loan index associated with subprime ARMs following expiration of the initial rate, subprime ARM borrowers who stayed in their mortgage more than two and a half years would be slated to pay more for their mortgage than those who took out subprime fixed rate.

When Federal regulators finally proposed to require lenders to underwrite loans to the fully-indexed, fully-amortizing payment schedule that would apply after expiration of initial rates, interest-only periods, and negative amortization, the response from industry was telling. In fact, at the time, Countrywide estimated that 70% of their recent borrowers would be unable to meet this common-sense standard.[134] Industry's response represented an admission that they had been making unsustainable loans that would eventually result in unaffordable payments.

b. Low and no doc loans

Exaggerating borrower income is another way to sell borrowers mortgages they can't sustain. Within the troubled subprime sector, a near-majority of loans were made without full documentation of income. As Figures 11 shows, this was a strong trend, climbing from 26% of subprime mortgages in 2000 to 44% in 2005.[135] Alt-A option ARMs, particularly among recent entrants in making these loans, had an even greater incidence of loans with less than full-documentation, particularly the newer entrants providing this loan type: by 2006, 9 of 10 such loans were made without full documentation up from the already high mark of 1 in 5 in 2000. Other types of Alt A loans were similarly skimpy on documentation of income or assets.[136]

Figure 11: No- and Low-Documentation Loans 2000 and 2006, by segment



Sources: Li and Ernst, Fitch Ratings[137]

c. Failure to escrow for taxes and insurance

Failure to escrow for taxes and insurance was yet one more way to fool families into thinking they could afford mortgages they couldn't afford. The failure to escrow occurred mainly in the subprime market[138] and has contributed to higher rates of foreclosure.[139] By creating artificially low monthly payment figures, the failure to escrow deceived borrowers about the actual cost of these mortgages relative to those offered by competitors that do escrow.[140] It also put families in the position of facing an unexpected tax bill, and made them targets for new high-cost refinancings. Moreover, homeowners who did not escrow were much more likely to be subjected to the unnecessarily high cost of force-placed insurance.[141] Because lenders could generate significant fees from force-placing insurance, the lack of an escrow requirement provided an opportunity for them to increase their revenue.

APPENDIX B

FUNDAMENTAL PRINCIPLES ESSENTIAL TO A PROPERLY FUNCTIONING MARKET

I. SUSTAINABLE MORTGAGES BASED ON SOUND UNDERWRITING

In many respects, the risky mortgages of recent years appear modern, advanced, and complicated. In reality, these unsustainable mortgages marked a big step backward—a return to mortgages prevalent before the Great Depression, that required borrowers to get a new loan when it expired and, therefore, housing appreciation. These loans were five-year balloon loans, which are antecedents to the 2/28 exploding subprime ARM, or poorly underwritten nontraditional mortgages that build in substantial payment shock.

We can find useful guidance in the successful solution implemented at that time. The Home Owners' Loan Corporation (HOLC) was established in 1933 to help distressed families avoid foreclosure by buying mortgages at a discount from the banks that held them, and restructuring five-year, often non-amortizing loans into loans that borrowers could afford and sustain—15-year, amortizing loans at a fixed maximum interest rate of 5%.[142] This massive intervention had extraordinary impact, ameliorating a housing crisis in which almost half of all mortgages were in default.[143]

The Federal Housing Administration and Fannie Mae, and later Freddie Mac, were established to facilitate widespread provision of the type of long-term, fixed-rate, sustainable loans that HOLC provided. All require 30-year terms, principal amortization, documentation of income, and escrow of taxes and insurance—the responsible loan features and underwriting practices that have been abandoned by so many in recent years.

We must return to a system of sustainable mortgages based on sound underwriting practices:

- Ability to repay, the fundamental tenant of mortgage lending, must be assessed, taking the following into account:
  - The debt-to-income measure must be at a reasonable level, should take into account all debt payments, including principal, interest, taxes and insurance, any other mortgages, and other household debt.
  - There should be an assessment of residual income to ensure that there are adequate resources available to cover family living expenses after deducting debt service requirements from monthly income.
  - Documentation is crucial, and verification should be made based on W-2 and 1099 forms, tax records, bank records, and/or other reasonable third-party documents.

- ➢ The use of loan-to-value ratios is inappropriate in the ability to repay context, because it does not relate to a borrower's monthly income.

- Prepayment penalties should be banned on all subprime and nontraditional loans;

- Escrow of taxes and insurance should be required for all subprime and nontraditional loans.

The Federal Reserve's recent HOEPA rules are a significant step in the right direction. However, they do not address ability to repay, prepayment penalties, or the need to escrow on nontraditional loans, leaving a critical gap in the regulatory framework.

II. ALIGNMENT OF INCENTIVES

FDIC Chairman Sheila Bair recently noted, referring to the separation of origination, funding and servicing segments in the securitization model: "If we want private securitization to ever work again, we need a workable compensation scheme that aligns the interests of all the players in the game."[144] In short, there must be skin in the game all the way up the chain. Assignee liability, elimination of abusive yield-spread premiums, enforceable originator duties, and requiring that investors pay rating agencies instead of issuers are essential changes needed to ensure healthy alignment of incentives in the market.

A. Assignee liability

We have now learned beyond a shadow of a doubt that Wall Street will incent loan structures best for their short term profits, unrelated to long-term borrower interests, and that originators will supply the loans for which they are paid the most. It is also clear that regulators are not up to task of policing millions of thousands of loan originations.

The best way to re-align the interests of borrowers and lenders is for Congress to insist on meaningful assignee liability.[145] When assignee liability exists, the borrower is allowed to pursue legal claims against the assignee when the loan transaction involves illegal actions or abusive terms. In the case of the mortgage market, strong assignee liability would mean that when a trust purchases mortgages, with all the corresponding financial benefits, it also accepts reasonable liability for when the mortgages prove to be abusive and harm homeowners, and therefore the investors will pay a financial price.

Assignee liability can be tightly drawn but must satisfy the principle that an innocent borrower who has received an illegal loan must be able to defend that loan in foreclosure as compared with an equally innocent assignee. This is for two reasons: first, the assignee can spread this loss across thousands of other loans, while the borrower has but one home. Second, the assignee can choose who to buy their loans from; as a result, they can choose only reputable originators likely to make quality mortgages that are strong enough to purchase the loan back if it violates representations warranties that the secondary market purchaser imposes.

Public enforcement can never be adequate: there is a shortage of resources to match against the millions of loans made to borrowers, and in some cases, a lack of will to take significant action.

Investigations will inevitably be too slow for the homeowners who face foreclosure in the meantime, and while public enforcement can achieve some relief, it will rarely, if ever, be enough to make most individual borrowers whole. Assignee liability effectively uses the market to decentralize oversight of loans purchased—no one will better ensure that loans are originated to specified standards than investors who carry the associated financial and legal risk.

Assignee liability also helps to protect responsible investors from misperceived risks and provides incentives for the market to police itself, curbing market inefficiencies. And assignee liability is not a new concept; it exists in several other contexts related to lending.[146]

B. Prohibition of prepayment penalties and high loan fees on subprime and nontraditional loans.

Prepayment penalties and high loan fees reward originators that produce abusive subprime and nontraditional loans by paying them handsomely regardless of the long-term sustainability of the loan. To eliminate the disastrous effects of such perverse incentives, they should be banned on these loans.

C. Prohibition of abusive yield-spread premiums

We discuss earlier in this testimony the perverse incentives driven by abusive yield-spread premiums—one of the most reprehensible practices in the subprime mortgage market, yet one the Board's recent final HOEPA rule did not address. Banning yield-spread premiums would significantly reduce incentives for brokers to upsell borrowers into more expensive and riskier loans than those for which they qualify. Absent a ban on yield-spread premiums, any payment of such a premium by a lender should be recognized as a per se acknowledgment of agency between the broker and originating lender, with liability for the broker's acts and omissions irrebuttably attaching to the originating lender and subsequent holders of the note.

D. Duties

Clarifying the duty of care that originators have toward their borrowers is a critical step in promoting sustainable loans that serve both homeowners and investors as well as communities and neighbors. Brokers hold themselves out as trusted guides to borrowers, and they should be held to this standard. Brokers should be deemed to owe a fiduciary duty, including loyalty, avoidance of conflicts of interest between themselves and the homeowners, and use of reasonable care in pursuing the borrowers' interests. If duty standards applied only to brokers, then brokers may avoid special broker rules by table-funding the loan; therefore, duty standards should apply to all originators.

E. Requirement that investors pay rating agencies instead of issuers.

The only way to ensure that rating agencies provide objective and accurate ratings is to change their financial relationship with the issuers of mortgage-backed securities. Securities issuers have an incentive to distort the truth about what's in these securities pools. Investors, on the other hand, have an incentive to get the best information possible about the makeup of the deals they put their money into. So it should be the investors—not the issuers—who pay the rating agencies for their assessments of mortgage-backed securities.

III. ADEQUATE OVERSIGHT

Regulators' glaring failure to provide adequate oversight within their existing regulatory structures was a key cause of this crisis. Adequate oversight is vital to a healthy market—both to protect consumers and to ensure safety and soundness of the financial system. As Sheila Bair recently stated, "Protecting the consumer from . . . perils is not simply a do-good public service. In fact, consumer protection, and safe and sound lending practices are two sides of the same coin."[147]

For consumer protections to be meaningful, they must be enforceable, as provided for by S 2452, Chairman Dodd's Homeownership Preservation and Protection Act of 2007.

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[1] Statement by Michael Fratantoni, senior economist with Mortgage Bankers Association, MBA as quoted by Kirstin Downey in *Dim Forecast for Risky Mortgages*, Washington Post, December 20, 2006.

[2] See CRL issue paper, *Subprime Lending: A Net Drain on Homeownership* (March 27, 2007), *available at* http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf.

[3] For a detailed discussion of judicial loan modifications, *see* our previous testimony, Testimony of Eric Stein, Center for Responsible Lending, Before the U.S. Senate Judiciary Committee, Dec. 5, 2007, *available at* http://www.responsiblelending.org/pdfs/stein-statement-to-senate-judiciary-looming-foreclosure-crisis.pdf.

[4] Under current proposals, loan modifications would be available only where the homeowner's income is insufficient, after deducting for modest IRS-approved living expenses, to cover the mortgage payments. In addition, there is a good faith requirement that allows courts to exclude anyone who wrongly makes it through existing hurdles.

[5] The same phenomenon occurred when Chapter 12 was passed to modify loans on family farms in the late 1980s.

[6] *Lewis Ranieri to deliver Dunlop Lecture on Oct. 1*, Harvard University Gazette, Sept. 25, 2008, *available at* http://www.news.harvard.edu/gazette/2008/09.25/06-dunlop.html.

[7] Lewis S. Ranieri, "Revolution in Mortgage Finance," the 9th annual John T. Dunlop Lecture at Harvard Graduate School of Design, Oct. 1, 2008, *available at* http://www.jchs.harvard.edu/events/dunlop_lecture_ranieri_2008.mov (last visited Oct. 13, 2008). Ranieri, is "chairman, CEO, and president of Ranieri & Co. Inc. and chairman of American Financial Realty Trust, Capital Lease Funding Inc., Computer Associates International Inc., Franklin Bank Corp., and Root Markets Inc. He has served on the National Association of Home Builders Mortgage Roundtable since 1989. . . ." *Harvard University Gazette*, Sept. 25, 2008.

[8] For a more detailed discussion of assignee liability, *see* our previous testimony, Testimony of Michael D. Calhoun, Center for Responsible Lending, Before the U.S. House Committee on Financial Services Subcommittee on Financial Institutions and Consumer Credit, May 8, 2007, *available at* http://www.responsiblelending.org/pdfs/Sec_Market_Testimy-Calhoun-FINAL-_2_.pdf. For another account recommending lifting current restrictions on assignee liability, *see* Ren S. Essene and William Apgar, Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans, Joint Center for Housing Studies

–Harvard University (April 25, 2007), *available at* http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf.

[9] Since 1976, under the Federal Trade Commission Act, there has been assignee liability for many home improvement and mobile home mortgages that are nevertheless regularly securitized. The federal Truth in Lending Act likewise provides for limited assignee liability outside of HOEPA as well as a right of rescission that applies to assignees. Car loans also widely carry assignee liability into the securitization market under many state retail installment sales laws. Even standard commercial law, enacted in virtually every state through the Uniform Commercial Code, provides for some degree of assignee liability. For further discussion, *see* Testimony of Michael D. Calhoun, May 8, 2007.

[10] *See* Center For American Progress, Issue Brief: Overcoming Legal Barriers to the Bulk Sale of At-Risk Mortgages, April 2008, *available at* http://www.americanprogress.org/issues/2008/04/reimc_brief.html.

[11] Median usual weekly earnings of employed full time wage and salary workers data from the Current Population Survey, retrieved from U.S. Bureau of Labor and Statistics website. Even at the 75th and 90th percentiles of wages, real wage gains have been limited to 4.8% and 8.7%, respectively. Housing price data from Standard and Poor's S&P / Case-Shiller Home Price Indices and CPI from the Bureau of Labor Statistics.

[12] Sharad Chaudhary, "An Introduction to the Subprime Mortgage Sector", Bank of America RMBS Trading Desk Strategy (June 27, 2007).

[13] Wei Li and Keith Ernst, "Do State Predatory Lending Laws Work?", Housing Policy Debate, Vol. 18, Issue 2 at page 361 (2007), *available at* http://www.mi.vt.edu/data/files/hpd%2018.2/6.hpd_wei-ernst_web.pdf.

[14] *Id.* Moreover, a huge portion of so-called "stated-income" loans were underwritten using dramatically inflated incomes when compared to IRS documents (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)) and lenders routinely failed to verify income even when they could have done so easily. *See, e.g.*, Gretchen Morgenson, *Inside the Countrywide Spending Spree*, New York Times, Aug. 26, 2008; Mike Hudson, Center for Responsible Lending, *IndyMac: What Went Wrong: How an "Alt-A" Leader Fueled Its Growth With Unsound and Abusive Mortgage Lending*, June 30, 2008, *available at* http://www.responsiblelending.org/pdfs/indymac_what_went_wrong.pdf (hereafter IndyMac Report).

[15] Most homeowners with prime mortgages maintain escrow accounts. *See, e.g.,* Fannie Mae "Single Family Selling Guide" Part VII, Section 104.05 ("First mortgages generally must provide for the deposit of escrow funds to pay as they come due taxes, ground rents, premiums for borrower-purchased mortgage insurance (if applicable), and premiums for hazard insurance and flood insurance...")

[16] *See* Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground*, Center for Responsible Lending (Dec. 2006), *available at* http://www.responsiblelending.org/pdfs/FC-paper-12-19-new-cover-1.pdf.

[17] Countrywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," Oct. 26, 2007.

[18] Credit Suisse, *Foreclosure trends—A sobering reality: 6.5 million borrowers expected to fall into foreclosure over the next five years*, April 23, 2008.

[19] MBA National Delinquency Survey, 2nd quarter 2008. The 5.5 million reported by survey, divided by 0.85 to scale up to market size (accounting for underreporting), multiplied by 0.047, the 2Q 2008 foreclosure start rate, multiplied by 4 to annualize. Another 1.2 million were delinquent but not in foreclosure, and another 492,000 were sitting in foreclosure from previous quarters' foreclosure starts.

[20] In May of 2007, MBA Chairman said: "As we can clearly see, this is not a macro-economic event. No seismic financial occurrence is about to overwhelm the U.S. economy." Statement of John M. Robbins, CMB, Chairman, Mortgage Bankers Association at the National Press Club's Newsmakers Lunch – Washington, DC (May 22, 2007),

available at http://64.233.169.104/search?q=cache:DClB6ScFSu8J:www.mortgagebankers.org/files/News/InternalResource/54451_NewsRelease.doc+%22seismic+financial+occurrence%22+%26+John+M.+Robbins+%26+mortgage+bankers+association&hl=en&ct=clnk&cd=4&gl=us; *see also* Julia A. Seymour, "Subprime Reporting , Networks blame lenders, not borrowers for foreclosure 'epidemic,'" Business & Media Institute (Mar. 28, 2007) ("[T]here are experts who say the subprime 'meltdown' is not the catastrophe reporters and legislators are making it out to be. 'We don't believe it will spill over into the prime market or the U.S. economy,' said [Laura] Armstrong [Vice President, Public Affairs] of the Mortgage Bankers Association.").

[21] *See* Jody Shenn, *Libor Rise to Boost Subprime ARM Defaults 10%, Citigroup Says*, Bloomberg News, Oct.7, 2008.

[22] One in four Option ARMs made between 2004 and 2007 and still outstanding is delinquent. Sixteen percent are seriously delinquent (90 days + , REO, or in foreclosure). Upcoming payment shocks on these loans typically range from increases of 50% to 150% on required payments. Fitch Ratings, *Option ARMs: It's Later Than It Seems*, Structured Finance Residential Mortgage Special Report, Sept.2, 2008.

[23] James R. Hagerty and Ruth Simon, *Housing Pain Gauge: Nearly 1 in 6 Owners "Under Water,"* Wall Street Journal, Oct. 8, 2008, *available at* http://online.wsj.com/article/SB122341352084512611.html?mod=googlenews_wsj.

[24] Kristopher Gerardi, Adam Hale Shapiro, and Paul S. Willen, Federal Reserve Bank of Boston Working Papers, Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures, May 4, 2008, *available at* http://www.bos.frb.org/economic/wp/wp2007/wp0715.pdf.

[25] Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, (vol. 18, issue 2, 2007), *available at* http://www.mi.vt.edu/data/files/hpd%2018.2/5.hpd_quercia_web.pdf.

[26] These new projections, representing only property value declines caused by nearby foreclosures, not other price drops associated with the slowdown in local housing markets, are based on CRL research combined with data from Merrill Lynch, Moody's Economy.com, and the Mortgage Bankers Association. CRL Issue Brief, *Updated Projections of Subprime Foreclosures in the United States and Their Impact on Home Values and Communities,* Rev. Aug. 2008, *available at* http://www.responsiblelending.org/issues/mortgage/research/updated-projections-of-subprime-foreclosures-in-the-united-states-and-their-impact-on-home-values-and-communities.html.

[27] *See* HOPE NOW Data spanning July 2007 to July 2008, *available at* http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf (reporting higher prime and subprime loans seriously delinquent as of July 2008 than any previous month reported).

[28] HOPE NOW Data, July 2008, *available at* http://www.hopenow.com/upload/data/files/July%202008%20Industry%20Extrapolations.pdf (reporting 197,000 foreclosure starts and 192,000 repayment plans initiated and modifications completed, combined in July 2008).

[29] Analysis of Subprime Servicing Performance , State Foreclosure Prevention Working Group, Sept. 2008, *available at* http://www.mass.gov/Cago/docs/press/2008_09_29_foreclosure_report_attachment1.pdf.

[30] Inside Mortgage Finance Reprints, Subprime Debt Outstanding Falls, Servicers Pushed on Loan Mods (Nov. 16, 2007) (Quoting Karen Weaver, a managing director and global head of securitization research at Deutsche Bank Securities).

[31] Credit Suisse, *Mortgage Liquidity du Jour: Underestimated No More* (March 12, 2007) at 5.

[32] Credit Suisse, *Subprime Loan Modifications Update*, Oct. 1, 2008, at p. 8.

[33] See Credit Suisse, *The Day After Tomorrow: Payment Shock and Loan Modifications*, Apr. 5, 2007 (noting specific examples of PSAs with various modification restrictions, including 5% by balance, 5% by loan count, limits on frequency, and limits on interest rate).

[34] *See, generally*, Gretchen Morgenson, *Silence of the Lender: Is Anyone Listening?*, New York Times, July 13, 2008.

[35] Homeownership Preservation Summit Statement of Principles (May 2, 2007), *available at* http://dodd.senate.gov/index.php?q=node/3870/print (The Principles were announced by Senator Dodd and endorsed by the Mortgage Bankers Association, CitiGroup, Chase, Litton, HSBC, Countrywide, Wells, AFSA, Option One, Freddie Mac, and Fannie Mae).

[36] State Foreclosures Working Group, Sept. 2008.

[37] Credit Suisse, *Subprime Loan Modifications Update*, Oct. 1, 2008.

[38] For more on aggressive marketing, *see* Ren S. Essene and William Apgar, *Understanding Mortgage Market Behavior: Creating Good Mortgage Options For All Americans*, Joint Center For Housing Studies At Harvard University (April 25, 2007), *available at* http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf.

[39] *Who's Holding the Bag?*, Presentation by Pershing Square Capital Management, L.P., p. 9 (May 2007), *available at* http://www.designs.valueinvestorinsight.com/bonus/pdf/IraSohnFinal.pdf (last visited Oct. 14, 2008).

[40] Jon Meacham and Daniel Gross, *The Oracle Reveals All: Did the Fed Cause the Real Estate Bubble to Burst? Are We Entering a Recession? And Who Should Be Our Next President? A Candid Conversation*, Newsweek (September 24, 2007).

[41] Brad Hintz, Michael Werner and Bryan St. John, "U.S. Securities Industry: The Sub-Prime Mortgage Blues," Bernstein Research, Feb. 16, 2007.

[42] At the time of its failure, for example, Bear Stearns leverage ratio exceeded 35 to 1. Roddy Boyd, *The Last Days of Bear Stearns*, Mar. 31, 2008, *available at* http://money.cnn.com/2008/03/28/magazines/fortune/boyd_bear.fortune/.

[43] Roger Lowenstein, "Triple-A Failure," New York Times Magazine, April 27, 2008.

[44] In one study, Lowenstein notes, a Drexel University researcher compared default rates (during the boom years before the mortgage bubble burst) on corporate bonds rated Baa and collateralized debt obligations with similar ratings. The CDOs—which were generally stocked with mortgage-related securities—defaulted at a rate eight times as often as their corporate cousins. Lowenstein: "One interpretation of the data is that Moody's was far less discerning when the client was a Wall Street securitizer."

[45] Lowenstein, "Triple-A Failure."

[46] *Id.*

[47] Gretchen Morgenson, *Inside the Countrywide Spending Spree*, New York Times (August 26, 2008).

[48] Vikas Bajaj and Christine Haughney, *Tremors at the Door: More People with Weak Credit Are Defaulting on Mortgages*, New York Times (January 26, 2007).

[49] One look at a broker's rate sheet makes it clear that brokers had every financial incentive to make riskier, more expensive loans. As recently as February 2008, Bear Stearns' rate sheet told its brokers that their maximum 1%

yield-spread premium would be cut in half on loans without a prepayment penalty. Bear Stearns, Wholesale Subprime Discount Rate Sheet, Feb. 19, 2008, on file with CRL.

[50] Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, Wall Street Journal at A1 (Dec. 3, 2007).

[51] Letter from Coalition for Fair & Affordable Lending to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner (Jan. 25, 2007) at 3.

[52] *See, e.g.*, Glenn R. Simpson and James R. Hagerty, *Countrywide Loss Focuses Attention on Underwriting*, Wall Street Journal (Apr. 30, 2008).

[53] *Steered Wrong, supra* note 2. *Id.* That extra money, of course, is paid by the consumers in those subprime loans who could have—*should* have—been in the lower cost prime loans, and, but for the perverse incentives making those loans better for the middlemen, might have been.

[54] *See* Testimony of Harry H. Dinham, President, National Association of Mortgage Brokers, before the U.S. House of Representatives Committee on Financial Services' Subcommittee on Financial Institutions and Consumer Credit, March 27, 2008, at 8.

[55] *See, e.g.*, Gretchen Morgenson, *Illinois to Sue Countrywide*, N.Y. Times, June 25, 2008 (noting that the Illinois Attorney General's complaint alleges that the "vast majority" of loans made by one Illinois mortgage broker had inflated income, "almost all without the borrower's knowledge.").

[56] *See* Gretchen Morgenson and Geraldine Fabrikant, *Countrywide's Chief Salesman and Defender*, N.Y. Times, Nov. 11, 2007 (noting former employee who said commission structure rewarded sales representatives for making risky, high-cost loans, including, for example, a commission increase of 1% of loan value for attaching a three-year prepayment penalty; noting that the higher the interest at reset, the higher the broker's commission).

[57] Ruth Simon and James R. Hagerty, *Countrywide's New Scare— Option ARM' Delinquencies Bleed Into Profitable Prime Mortgages*, Wall Street Journal, Oct. 24, 2007.

[58] Mike Hudson, Center for Responsible Lending, *IndyMac: What Went Wrong: How an "Alt-A" Leader Fueled Its Growth With Unsound and Abusive Mortgage Lending*, June 30, 2008, *available at* http://www.responsiblelending.org/pdfs/indymac_what_went_wrong.pdf (hereafter IndyMac Report).

[59] IndyMac Report at 2 (IndyMac approved a brokered loan claiming an 80-year-old living solely on SSI earned nearly $4,000 per month; IndyMac instructed a mortgage broker to send SSI letters with the dollar amount expunged: "Need copy of SSI letter blacked out for the last 2 yrs w/no ref to income" (citing Manuel v. American Residential Financing, Inc., et al, Superior Court of Gwinnett County, State of Georgia, April 3, 2008)).

[60] IndyMac Report at 3 (citing IndyMac Bancorp Inc., 8K filing with Securities and Exchange Commission, May 12, 2008. Before its demise, IndyMac had moved decidedly back in the direction of fully documenting borrowers income and other particulars, with 69% of its loan volume in March 2008 involving "full-doc" mortgages).

[61] In *re: New Century TRS Holdings, Inc., a Delaware corporation, et al.*, Final Report of Michael J. Missal, Bankruptcy Court Examiner, Chapter 11, Case No. 07-10416 (KJC), Feb. 29, 2008, *available at* http://www.klgates.com/FCWSite/Final_Report_New_Century.pdf at 130.

[62] Debra Cassens Weiss, *New Century GC Sounded Early Warning About Subprime Exposure*, ABA Journal, March 31, 2008.

[63] For example, prepayment penalties in the subprime market have been demonstrated to increase foreclosure rates 16 to 20 percent. Quercia. Stegman, & Davis, *supra*. However, the Board did nothing to rein them in until July of this year.

[64] Representative Leach, Hearing on Predatory Lending Practices, U.S. House Committee on Banking and Financial Services, May 24, 2000, *available at* http://commdocs.house.gov/committees/bank/hba64810.000/hba64810_0.htm (last visited Oct. 10, 2008).

[65] Testimony of Martin Eakes, CEO, Center for Community Self-Help, Before the House Committee on Banking and Financial Services, May 24, 2000, *available at* http://financialservices.house.gov/banking/52400eak.htm#N_14_.

[66] *See* Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending (Feb. 23, 2006), *available at* http://www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf.

[67] *See* Stephen Labaton, *Agency's '04 Rule Let Banks Pile on Debt*, N.Y. Times, Oct. 2, 2008.

[68] Press Release, Securities and Exchange Commission, , Chairman Cox Announces End of Consolidated Supervised Entities Program (publishing Written Statement of Christopher Cox), Sept. 26, 2008.

[69] Labaton, *Agency's '04 Rule Let Banks Pile on Debt*, N.Y. Times, Oct. 2, 2008 (citing an inspector general's report issued Sept. 26, 2008).

[70] Steve Dunbar, *Unregulated Swaps Hastened Wall Street Collapse*, Associated Press, Oct. 7, 2008 (quoting Michael Greenberger, former director of trading and markets for the Commodity Futures Trading Commission: "Were it not for that insurance, it certainly wouldn't have reached this manic state of growth," Greenberger said of the questionable investments.).

[71] *Id.* (citing estimates of notional value from the International Swaps and Derivatives Association as of the end of 2007 and noting that the figure is "roughly five times the entire U.S. production of goods and services last year.").

[72] Former Comptroller John D. Hawke, Jr. described the OCC's use of its power to override state laws protecting consumers as "one of the advantages of a national charter," and asserted that he was "not the least bit ashamed to promote it." The fact that the OCC is funded by assessments from the banks it regulates, rather than by Congressional appropriations (in 2005, 97% of the OCC's operations were funded by revenues from assessments), feeds a race to the bottom to attract institutions to its charter. *See* OCC, Annual Report, Fiscal Year 2005 at 7, *available at* www.occ.treas.gov/annrpt/2005AnnualReport.pdf; Jess Bravin & Paul Beckett, "Friendly Watchdog: Federal Regulator Often Helps Banks Fighting Consumers– Dependent on Lenders' Fees, the OCC Takes Banks' Side Against Local, State Laws," at A1 *Wall St. Journal* (Jan. 28, 2002).

[73] *See* 68 Fed. Reg. 46264 (Aug. 5, 2003); 68 Fed. Reg. 46119 (Aug. 5, 2003). *See also* 68 Fed. Reg. at 1911-12 nn.57, 59 (invoking the Georgia law as an example of the application of its preemption standard); *see also* Nicholas Bagley, *The Unwarranted Regulatory Preemption of Predatory Lending Laws*, 79 N.Y.U.L. Rev. 2274, 2295 (2004). For thoughtful academic criticisms of the OCC's preemption of state anti-predatory lending laws and other consumer protection laws, *see generally* Azmy, 57 Fla. L. Rev. at 295 (discussing the Georgia Fair Lending Act preemption at pages 385-88); Christopher L. Peterson, 78 Temple L. Rev. at 1, *supra*; Bagley, *Id.*; Vincent DiLorenzo, "Federalism, Consumer Protection and Preemption: A Case for Heightened Judicial Review," *St. John's Legal Studies Research Paper #09-0026* (Sept. 2005), *available at* http://ssrn.com/abstract=796147; Arthur E. Wilmarth, Jr., "The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection," 23 *Ann. Rev. of Banking & Fin. Law*, 225, 232 (2004).

[74] Robert Berner & Brian Grow, "They warned us about the Mortgage Crisis," *Business Week* (Oct. 9, 2008), *available at:* http://www.businessweek.com/magazine/content/08_42/b4104036827981.htm.

[75] *Id.*

[76] *Id.* (quoting North Carolina Attorney General Roy Cooper).

[77] *Id.*

[78] *See, e.g.*, OCC News Release 2003-8: OCC Issues Guidelines to National Banks to Guard Against Abusive Lending Practices (Feb. 21, 2003) (comments by Comptroller Hawke that "while the OCC has *no reason to believe that any national bank is engaging in predatory lending*, the agency's guidance will help prevent problems from arising in the future by prescribing steps national banks should take to avoid abusive practices."); Statement Of Comptroller Of The Currency John D. Hawke, Jr. Regarding The Issuance Of Regulations Concerning Preemption And Visitorial Powers (Jan. 7, 2004) ("We have no evidence that national banks (or their subsidiaries) are engaged in such practices to any discernible degree."); OCC, News Release 2004-3: OCC Issues Final Rules on National Bank Preemption and Visitorial Powers; Includes Strong Standard to Keep Predatory Lending out of National Banks (Jan. 7, 2004) ("There is scant evidence that regulated banks are engaged in abusive or predatory practices").

[79] Robert Berner & Brian Grow, "They warned us about the Mortgage Crisis," *Business Week* (October 9, 2008). The OCC's response to consumer complaints has been equally unimpressive. Although the OCC is required to have a separate consumer affairs division, 15 U.S.C. § 57a(f)(1), and largely relies on direct consumer contact with the bank as "the most effective way to resolve a complaint ..." *See* OCC, Annual Report Fiscal Year 2004, at 19 (Oct. 2004), *available at* http://www.occ.treas.gov/annrpt/2004AnnualReport.pdf; OCC, 2004 Report of the Ombudsman, at 38 (Dec. 2004), *available at* http://www.occ.treas.gov/2004Report.pdf.

[80] This bank failed and was taken over by the FDIC on March 12, 2004. *See* http://www.fdic.gov/bank/individual/failed/gnb.html.

[81] Center for Responsible Lending, "Comments on OCC Working Paper" at 8-10 (Oct. 6, 2003), *available at* http://www.responsiblelending.org/pdfs/CRLCommentsonOCCWorkingPaper.pdf. The practices included charging exorbitant broker fees, imposing unfair prepayment penalties, evading HOEPA and other consumer protection laws, the high prevalence of 2/28 ARM loans accompanied by 3-year prepayment penalty provisions, as well as racial steering and lending discrimination. *Id.*

[82] Yalman Onaran, "Banks' Subprime Losses Top $500 Billion on Writedowns (Update 1)" (Aug. 12, 2008), *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=a8sW0n1Cs1tY&refer=home#.

[83] *Id.*

[84] Countrywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," October 26, 2007.

[85] Lehman Brothers, "Residential Credit: Estimating Option ARM Losses" at 4 *MBS Strategy Weekly* (June 20, 2008).

[86] Office of Inspector General, Department of the Treasury, "Material Loss Review of NetBank, FSB," April 23, 2008; OIG-08-032, p. 1.

[87] *Id.* at 3.

[88] The bank had roughly $307 billion in assets and $188 billion of deposits. WaMu was nearly 700% bigger than the largest previous U.S. bank to fail, Continental Illinois National Bank & Trust, which had $40 billion in assets when it went under in 1984.

[89] *Ferguson v. IndyMac Bank*, U.S. District Court for the Eastern District of New York, filed Feb. 14, 2008, *available at* http://www.responsiblelending.org/pdfs/indy-ferguson-brooklyn.pdf.

[90] IndyMac's dollar volume of non-performing assets exploded 11-fold in 15 months—going from $184 million (0.63% of assets) at the close of 2006 to $2.1 billion (6.51% of assets) at the end of the first quarter of 2008. Highline Financial—a research service that rates the safety of banks and thrifts on a 99 (best) to zero (worst) scale—

dropped its rating on IndyMac from 55 at the end of 2006 to 1 at the end of 2007—and then down to zero in March 2008. Kathleen Pender, *Why wasn't IndyMac on FDIC problem list?*, San Francisco Chronicle, July 24, 2008.

[91] Karey Wutkowski, "FDIC says IndyMac failure costlier than expected," Reuters, August 26, 2008.

[92] Mark Gimein, "Inside the Liar's Loan," *Slate*, April 24, 2008; "Bring on the Alt-A Downgrades," *Mish's Global Economic Trend Analysis*, May 29, 2008.

[93] Pierre Thomas and Lauren Pearle, "Exclusive: WaMu Insiders Claim Execs Ignored Warnings, Encouraged Reckless lending," ABCNews.com, Oct. 13, 2008.

[94] *The People of the State of New York v. First American et al*, filed Nov. 1, 2007, New York County Supreme Court. WaMu was not named as a defendant in the case because of the federal preemption policy pushed by OTS and other federal regulators, which in many instances exempts federally licensed banks from action by state courts or state authorities.

[95] "NY Attorney General Sues First American And Its Subsidiary For Conspiring with Washington Mutual To Inflate Real Estate Values," Media Release, New York State Attorney General's Office, Nov. 1, 2007. In a private lawsuit filed two months later, a California appraiser claimed WaMu had blacklisted her because she refused to falsify appraisal documents. She alleged that WaMu officials took her off their preferred appraiser list in 2007 because she accurately reported that home values were falling in areas where she was doing appraisals. See Amir Efrati, "WaMu accused of Blacklisting Appraiser Over Home Prices," Dow Jones News Service, Jan. 17, 2008.

[96] Press Release, Freddie Mac, *Freddie Mac Announces Tougher Subprime Lending Standards to Help Reduce the Risk of Future Borrower Default*, Feb. 27, 2007, *available at* http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/02-27-2007/0004535243&EDATE.

[97] Statement of OFHEO Director James B. Lockhart on Issuance of Letters by Fannie Mae and Freddie Mac Regarding Nontraditional and Subprime Mortgage Products, July 17, 2007, *available at* http://www.ofheo.gov/NewsRoom.aspx?Q1=0&Q2=0&FormMode=Detail&ID=370.

[98] 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, Feb. 7, 2007, at 20, *available at* http://www.responsiblelending.org/pdfs/martin-testimony.pdf.

[99] *See, e.g.*, July 16, 2004 comment letter to HUD from Stephen Brobeck, Executive Director, Consumer Federation of America; Ira Rheingold, Executive Director National Association of Consumer Advocates; John Taylor, President and CEO, National Community Reinvestment Coalition; Roy O. Priest, President and CEO, National Congress for Community Economic Development; Sheila Crowley, President, National Low Income Housing Coalition; and June 30, 2004 comment letter to HUD from F. Barton Harvey III, Chairman of the Board and Chief Executive Officer, The Enterprise Foundation and Michael Rubinger, President, Local Initiatives Support Corporation.

[100] 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.

[101] For further discussions of how CRA has aided rather than harmed communities, *see* Janet L. Yellen, Opening Remarks to the 2008 National Interagency Community Reinvestment Conference, San Francisco, California (March 31, 2008) (noting that studies have shown that the CRA has increased the volume of responsible lending to low- and moderate-income households); Ann F. Jaedicke, Testimony Before the Committee on Financial Services, US House of Representatives (February 13, 2008) (nothing "over half of subprime mortgages of the last several years—and the ones with the most questionable underwriting standards—were originated through mortgage brokers for securitization by nonbanks, including major investment banks"); Michael S. Barr, "Credit Where It Counts:

Maintaining a Strong Community Reinvestment Act," Brookings Institution Research Brief (May 2005) (stating "encouraged by the law, banks and thrifts have developed expertise in serving low-income communities.").

[102] According to Michael Barr, 80 percent of subprime loans were made by players not covered under CRA: "More than half of subprime loans were made by independent mortgage companies not subject to comprehensive federal supervision; another 30 percent of such originations were made by affiliates of banks or thrifts, which are not subject to routine examination or supervision, and the remaining 20 percent were made by banks and thrifts [covered by CRA]." Testimony of Michael Barr, Before the House Committee on Financial Services, Feb. 13, 2008, *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/barr021308.pdf.

[103] Inside Mortgage Finance, 2008 Mortgage Market Statistical Annual, Volume 1 (2008). They accounted for $226 billion in loans out of a total subprime industry volume of approximately $1.2 trillion. Ameriquest was perhaps the most predatory of all lenders, paying a $325 million multi-state fraud settlement, and New Century is being investigated for accounting fraud and other alleged bad practices.

[104] Traiger & Hinckley LLP, The Community Reinvestment Act: A Welcome Anomaly in the Foreclosure Crisis Indications that the CRA Deterred Irresponsible Lending in the 15 Most Populous U.S. Metropolitan Areas, Jan. 8, 2008, available at http://www.traigerlaw.com/publications/traiger_hinckley_llp_cra_foreclosure_study_1-7-08.pdf, http://www.traigerlaw.com/publications/addendum_to_traiger_hinckley_llp_cra_foreclosure_study_1-14-08.pdf.

[105] *Id.*

[106] Daniel Gross, *Subprime Suspects: The Right Blames the Credit Crisis on Poor Minority Homeowners. This Is Not Merely Offensive, But Entirely Wrong*, Newsweek, *available at* http://www.newsweek.com/id/162789 .

[107] *Id.*

[108] Introduction to July 2008 Federal Reserve Final HOEPA rule, 12 CFR Part 226 Truth in Lending; Final Rule, 73 Fed. Reg. 44522, 44526.

[109] Wall Street Journal, *Subprime Debacle Traps Even Very Credit-Worthy as Housing Boomed, Industry Pushed Loans to a Broader Market* (December 3, 2007).

[110] CRL Research, *Net Drain.*

[111] *Id.*

[112] Based on data collected under the Home Mortgage Disclosure Act for loans made in 2006, the average subprime loan amount for owner-occupied, first lien, single-family homes was $205,700. The median price was $159,000.

[113] American Banker, Wachovia Alum Has Tips for an Industry Rebound (September 15, 2008).

[114] *See* Fannie Mae Single Family Selling Guide, *available at* http://www.allregs.com/efnma/index.asp?dv=0&id=a&ii=0&im=0&io=fnma&ip=/&iq=0&iv=0&iw=0&iy=0&iz=0&fc=0&fk=_&fm=0&fs=0&fv=0&sd=/&sm=1&sp=fnma&sq=_&st=_&sv=0&sx=/&sy=0&sz=0&t=0&tc=fnma&tp=/&td=0&ti=0&tm=0&to=fnma&tw=0&tv=0&tq=0&tx=/; Freddie Mac Seller/Servicer Guide, *available at* http://www.freddiemac.com/sell/guide/#.

[115] Testimony of Martin Eakes Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, "Preserving the American Dream: Predatory Lending Practices and Home Foreclosures," (Feb. 7, 2007), *available at* http://www.responsiblelending.org/pdfs/martin-testimony.pdf, at 3, 17-18.

[116] Center for Responsible Lending, "Freddie Mac Bans Unaffordable Subprime Home Loans," (Feb. 27, 2007), *available at* http://www.responsiblelending.org/press/releases/page.jsp?itemID=31767669.

[117] Major D. Coleman IV, Michael LaCour-Little, Kerry D. Vandell, *Subprime Lending and the Housing Bubble: Tail Wags Dog?*, Working Paper, Sept. 2, 2008, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1262365.

[118] *See* David Goldstein and Kevin G. Hall, "Private sector loans, not Fannie or Freddie, triggered crisis," McClatchy Newspapers (Oct. 11, 2008), *available at* http://www.mcclatchydc.com/251/story/53802.html ("Between 2004 and 2006, when subprime lending was exploding, Fannie and Freddie went from holding a high of 48% of the subprime loans that were sold into the secondary market to holding about 24%, according to data from Inside Mortgage Finance, a specialty publication. One reason is that Fannie and Freddie were subject to tougher standards than many of the unregulated players in the private sector who weakened lending standards, most of whom have gone bankrupt or are now in deep trouble. During those same explosive three years, private investment banks—not Fannie and Freddie—dominated the mortgage loans that were packaged and sold into the secondary mortgage market. In 2005 and 2006, the private sector securitized almost two thirds of all U.S. mortgages, supplanting Fannie and Freddie, according to a number of specialty publications that track this data.")

[119] *Inside the GSEs*, Jan. 3, 2007, p. 4. These securities are divided into tranches, with the AAA tranches being the least risky, and for this reason the easiest to sell to investors; because there was broad investor demand for them, their marketability didn't depend on the GSEs. The harder securities to sell are those from the subordinate tranches. These were made palatable to investors through the creation of collateralized debt obligations, which repackaged BBB tranches into, in part, a new set of AAA tranches, which help to further market the securities; to my knowledge the GSEs did not invest in CDOs. It was the ability to fund the riskiest portion of subprime mortgage loans that made possible the explosive growth of subprime lending. See Pershing Square Capital Management, L.P., Who's Holding the Bag, Presentation, May 2007, *available at* http://www.designs.valueinvestorinsight.com/bonus/pdf/IraSohnFinal.pdf.

[120] Federal Home Loan Mortgage Corporation, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.28, *available at* http://www.freddiemac.com/investors/; Federal National Mortgage Association, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.45, *available at* http://www.fanniemae.com/ir/pdf/earnings/2008/q22008.pdf.

[121] This is a one-time impairment charge, all of which Freddie Mac does not expect to ultimately lose; this is in contrast to on-going, recognized losses on Alt-A loans that are 50% or more of the total credit losses experienced year-to-date. See Federal Home Loan Mortgage Corporation, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.37 & 71, *available at* http://www.freddiemac.com/investors/.

[122] Fannie Mae, Investor presentation, "Fannie Mae 2008 Q2 10-Q Investor Summary," (Aug. 6, 2008), p.30, *available at* http://www.fanniemae.com/media/pdf/webcast/080808transcript.pdf.

[123] Charles Duhigg, Pressured to Take More Risk, Fannie Reached Tipping Point, N.Y. Times, Oct. 4, 2008.

[124] *Id.*

[125] Fannie Mae, Investor presentation, "Fannie Mae 2008 Q2 10-Q Investor Summary," (Aug. 6, 2008), p.36, *available at*: http://www.fanniemae.com/media/pdf/webcast/080808transcript.pdf.

[126] Federal National Mortgage Association, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.6, *available at* http://www.fanniemae.com/ir/pdf/earnings/2008/q22008.pdf; Federal Home Loan Mortgage Corporation, United States Securities and Exchange Commission Form 10-Q, for the quarterly period ended June 30, 2008, p.71, *available at* http://www.freddiemac.com/investors/.

[127] Freddie Mac, "Freddie Mac's Second Quarter 2008 Financial Results," Investor presentation, (Aug. 6,2008), p.4, available at: http://www.freddiemac.com/investors/.

[128] Tom Deutsch, Deputy Executive Director, American Securitization Forum, Milken Institute, "Financial Innovations Lab on Housing: Beyond the Crisis" (Oct. 7, 2008) at 11.

[129] *Available at* http://www.fanniemae.com/media/pdf/newsreleases/2008_Q2_10Q_Investor_Summary.pdf, at 37 (citing First American CoreLogic and LoanPerformance data).

[130] Median usual weekly earnings of employed full time wage and salary workers data from the Current Population Survey, retrieved from U.S. Bureau of Labor and Statistics website. Even at the 75th and 90th percentiles of wages, real wage gains have been limited to 4.8% and 8.7%, respectively. Housing price data from Standard and Poor's S&P / Case-Shiller Home Price Indices and CPI from the Bureau of Labor Statistics.

[131] Inside Mortgage Finance Publications, "The 2008 Mortgage Market Statistical Annual" (2008).

[132] Sharad Chaudhary, "An Introduction to the Subprime Mortgage Sector", Bank of America RMBS Trading Desk Strategy (June 27, 2007).

[133] CRL previous testimony has included these points.

[134] Countrywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," October 26, 2007.

[135] Wei Li and Keith Ernst, "Do State Predatory Lending Laws Work?", Housing Policy Debate, Vol. 18, Issue 2 at page 361 (2007) (available at http://www.mi.vt.edu/data/files/hpd%2018.2/6.hpd_wei-ernst_web.pdf).

[136] Moreover, a huge portion of so-called "stated-income" loans were underwritten using dramatically inflated incomes when compared to IRS documents (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)) and lenders routinely failed to verify income even when they could have done so easily. *See, e.g.*, Gretchen Morgenson, *Inside the Countrywide Spending Spree*, New York Times (August 26, 2008); Mike Hudson, Center for Responsible Lending, *IndyMac: What Went Wrong: How an "Alt-A" Leader Fueled Its Growth With Unsound and Abusive Mortgage Lending*, June 30, 2008, *available at* http://www.responsiblelending.org/pdfs/indymac_what_went_wrong.pdf (hereafter IndyMac Report).

[137] *See* Li and Ernst; Fitch Ratings, "Drivers of 2006-2007 Alt-A Collateral Performance" (May 7, 2008).

[138] Most homeowners with prime mortgages maintain escrow accounts. *See, e.g.,* Fannie Mae "Single Family Selling Guide" Part VII, Section 104.05 ("First mortgages generally must provide for the deposit of escrow funds to pay as they come due taxes, ground rents, premiums for borrower-purchased mortgage insurance (if applicable), and premiums for hazard insurance and flood insurance...")

[139] *See* Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground*, Center for Responsible Lending (Dec. 2006) at 27, *available at* http://www.responsiblelending.org/pdfs/FC-paper-12-19-new-cover-1.pdf.

[140] *See, e.g.,*. States' settlement agreement with Ameriquest, IV-B-5, http://www.state.ia.us/government/ag/images/pdfs/Ameriquest_SETTLMNT_FINAL.pdf; State of Iowa v. Household International, *Consent Judgment* Para. 9(E)(1), *available at* http://www.state.ia.us/government/ag/latest_news/releases/dec_2002/hhconsent.pdf; Federal Trade Commission vs. Citigroup, et al. Civ. No 1:01-CV-00606 (E.D. Ga., filed), Complaint, Para. 18-19, http://www.ftc.gov/os/2001/03/citigroupcmp.pdf.

[141] *Cf.* Federal Trade Commission "Facts for Consumers" *available at* http://www.ftc.gov/bcp/conline/pubs/homes/mortgserv.shtm ("It's important to maintain the required property insurance on your home. If you don't, your servicer can buy insurance on your behalf. This type of policy is known as force placed insurance; it usually is more expensive than typical insurance; and it provides less coverage.")

[142] David C. Wheelock, *The Federal Response to Home Mortgage Distress: Lessons from the Great Depression*, Federal Reserve Bank of St. Louis *Review*, May/June, Part 1, 2008.

[143] Pollock, p. 2. HOLC purchased and restructured more than a million mortgages, 20% of all mortgages in the country, and over the life of the program, extended $3.5 billion in loans (the corresponding figures in today's economy would be 2.5 million loans worth $750 billion). It closed its books in 1951 having turned a small profit. Alan S. Blinder, "From the New Deal, a Way out of a Mess," The New York Times (Feb. 24, 2008).

[144] Remarks by Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on The Future of Mortgage Finance at the 2008 Annual Meeting National Association for Business Economics; Washington, D.C., Oct. 6, 2008, *available at* http://www.fdic.gov/news/news/speeches/chairman/spoct0608.html (last visited Oct. 12, 2008).

[145] For a more detailed discussion of assignee liability, *see* our previous testimony, Michael D. Calhoun, Center for Responsible Lending, U.S. House Committee on Financial Services Subcommittee on Financial Institutions and Consumer Credit, May 8, 2007, *available at* http://www.responsiblelending.org/pdfs/Sec_Market_Testimy-Calhoun-FINAL-_2_.pdf. For another account recommending lifting current restrictions on assignee liability, *see* Ren S. Essene and William Apgar, Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans, Joint Center for Housing Studies – Harvard University (April 25, 2007), *available at* http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf.

[146] Since 1976, under the Federal Trade Commission Act, there has been assignee liability for many home improvement and mobile home mortgages that are nevertheless regularly securitized. The federal Truth in Lending Act likewise provides for limited assignee liability outside of HOEPA as well as a right of rescission that applies to assignees. Car loans also widely carry assignee liability into the securitization market under many state retail installment sales laws. Even standard commercial law, enacted in virtually every state through the Uniform Commercial Code, provides for some degree of assignee liability. For further discussion, *see* Testimony of Michael D. Calhoun, Center for Responsible Lending, U.S. House Committee on Financial Services Subcommittee on Financial Institutions and Consumer Credit, May 8, 2007, *available at* http://www.responsiblelending.org/pdfs/Sec_Market_Testimy-Calhoun-FINAL-_2_.pdf.

[147] Remarks by Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on The Future of Mortgage Finance at the 2008 Annual Meeting National Association for Business Economics; Washington, D.C., Oct. 6, 2008, *available at* http://www.fdic.gov/news/news/speeches/chairman/spoct0608.html (last visited Oct. 12, 2008).