Consumer Federation of America

TESTIMONY OF

ALLEN FISHBEIN
DIRECTOR OF HOUSING AND CREDIT POLICY
CONSUMER FEDERATION OF AMERICA

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
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COMMITTEE ON FINANCIAL SERVICES
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REGARDING

SUBPRIME AND PREDATORY LENDING: NEW REGULATORY GUIDANCE, CURRENT MARKET CONDITIONS AND EFFECTS ON REGULATED FINANCIAL INSTITUTIONS

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Good morning Chairmen Maloney, Ranking Member Gillmor and members of the Subcommittee. My name is Allen Fishbein, and I am the Director of Housing and Credit Policy for the Consumer Federation of America (CFA). I appreciate the opportunity to testify here today and we thank you for your holding this hearing to examine the problems of "Subprime and Predatory Lending: The New Regulatory Guidance, Current Market Conditions, and Effects on the Regulated Financial Institutions."

CFA is a national federation of some 300 pro-consumer organizations established in 1968 to engage in research, public education and advocacy in support of the interests of consumers. The goal of advancing sustainable homeownership is an important one for CFA and its members. For some time now, CFA has been concerned that the proliferation of non-traditional mortgage products in both the prime and subprime loan markets poses heightened risks for consumers. Indications are that many borrowers taking out these loans are not truly informed about their key features and the extra risks they entail. CFA has conducted consumer surveys along with other research and last year published a white paper on this topic. (See Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders.

This hearing could not be timelier. Turmoil in the subprime market brought on by rapidly escalating delinquencies and defaults has generated considerable public attention and concern. At last count, two dozen subprime lenders already have closed up shop, representing an estimated 15 percent of the industry and more may be on their heels. Investors world-wide have become jittery and there is talk that the problems in the subprime market may foreshadow problems to come for other segments of the mortgage market.

Thus this hearing is an opportune time to examine the sufficiency of steps that have been taken and whether additional action is warranted. The just proposed federal banking agency guidance regarding subprime lending should help to restore prudent underwriting for these loans. It should be adopted as quickly as possible and is much overdue. Speedy action also will be required by the states to adopt parallel guidance since the majority of the subprime loan market is under their watch. However, CFA believes that more focus should be directed at financial institutions, investors, government and the non-profit agencies to find creative solutions for keeping at-risk families who have been victimized by lax underwriting in their homes. The present environment also provides an opportunity to review the effectiveness of the present regulatory regime and determine the ways to improve the nation's consumer protection laws in this area.

My testimony makes three points to underscore what I have said above. First, changes to the mortgage market have contributed to the weak underwriting that has occurred in recent years and ultimately, to the greater risk exposure consumers now face; Second, I discuss why banking agency guidance should help, but further action by regulators still will be needed: Third, I discuss some ways that the current consumer protections laws can be strengthened.

1. The Face of the Changing Market and the Growth of Subprime Non-Traditional Lending

Homeownership can have many benefits, not the least of which is the opportunity it provides to build personal wealth. But these advantages are being eroded by the mass marketing of high-risk non-traditional mortgage products to many for whom they are not appropriate. What these loan products have in common is that they trade lower initial monthly payments for higher payments later that can escalate dramatically making loans unaffordable for unsuspecting borrowers. The abandonment in recent years by many lenders of careful underwriting based on the borrowers' ability to repay without refinancing or selling their home has made these loans even riskier.

Of particular concern are the hybrid adjustable rate mortgages (ARMs) that in recent years predominated the subprime loan market. The subprime market serves borrowers with weak or impaired credit who cannot meet the requirements for prime mortgages, whose rates typically are much lower. Subprime loans have been the fastest growing segment of the overall mortgage market.

Subprime hybrid ARMs typically feature initial short-term introductory rates (or "teaser" rate) for the first twenty-four or thirty-six months, which converts into an adjustable rate loan after that. Lenders maintained low teaser rates for these loans even after short-term rates began to rise, while increasing the amount the rate could adjust at the first reset period. Thus borrowers face exploding monthly payments of 30 percent or more even if interest rates did not rise. The concentration of hybrid ARMs among subprime borrowers has the additional risk of payment shock because they borrowers already are paying higher interest rates so subsequent increases are likely to be even more difficult to afford. As much as 80 percent of the subprime market has been comprised of these loans. In recent years, subprime borrowers have been qualified for hybrid ARMs based on their ability to repay under the lower teaser rate and not as the rate the loans adjusts to after the introductory period ends. The fact that layered risk elements, such as stated income, were used to loose underwriting standards for these loans.

Until about a year ago, rising home prices and relatively low interest rates made it possible for borrowers to refinance or sell their homes after the initial period ended or if they ran into trouble making payments. This served to mask the fact that many lenders were qualifying borrowers based on the loan's start rate. When home price appreciation leveled off last year delinquencies and defaults for these loans took off, rising to the highest levels in a decade.

And there are indications that the worse may be yet to come for borrowers holding these loans. The FDIC projects that 1 million ARMs are due to reset in 2007 and another 800,000 in 2008. The Center for Responsible Lending (CRL) modeled the performance of subprime loans and projects that one fifth (19.4 percent) of subprime borrowers over the past two years could enter foreclosure forcing 2.2 million households to lose their homes and a loss of up to $164 billion in wealth. Another recent study using more conservative assumptions still estimated that fully 13 percent of the adjustable-rate mortgages originated through purchase or refinance from 2004-2006 will enter foreclosure.[1]

Defaults and foreclosures could surge even higher depending on the resiliency of the housing market and interest rate movements. Delinquencies usually rise when the housing market slumps because borrowers are more likely to encounter difficulties in selling their homes. In addition, if prices fall, borrowers may find themselves without the necessary equity to refinance into a more affordable loan.

The widespread use of "exploding payment" ARMs and other payment deferred non-traditional mortgage products points to fundamental concerns about whether consumers really understand just how much their monthly payments can jump with these and other deferred payment non-traditional mortgage products.

a) *Evolution of the Subprime Market and the Emergence of Non-Traditional Products*

The subprime mortgage market serves those consumers who do not meet the credit standards to obtain a prime market. These loans typically feature higher interests rates and points and fees than prime mortgages, presumably to reflect the repayment risks these borrowers pose. Most subprime mortgages are refinance loans with borrowers using the collateral in their homes for debt consolidation and other consumer credit purposes. Subprime lending has grown rapidly as a segment within the conventional mortgage market.

The expansion of subprime lending has increased credit access for some, but prevalence of predatory loan practices associated with the growth of this market continues to raise important consumer protection concerns. Thirty states have adopted anti-predatory lending laws aimed at curbing abuses in the subprime market.

The "classic" predatory mortgage lending abuses entail excessively rates and points and fees, loan flipping (repeated refinancing), the packing of junk products, such as credit life insurance. Predatory mortgage loans typically also feature perverse market incentives, such as yield spread premiums and prepayment penalties, which reward mortgage brokers for increasing the loan price for borrowers. At its heart, predatory lending seeks to take advantage of the borrower's lack of understanding about loan terms, while often involving high pressure sales tactics, or even fraud.

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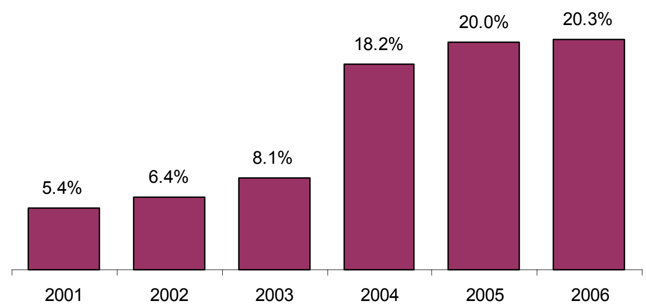
[1] Cagan, Christopher, "Mortgage Payment Reset: the Issue and the Impact," First American CoreLogic, March 19, 2007.

Subprime loans are disproportionately marketed to racial and ethnic minorities and also to the elderly. They are also concentrated in minority and low income communities. Research by the Federal Reserve Board and others have found that risk factors, such as credit scores, loan to value and debt to income rations, cannot fully explain the disparities that exist in this market across consumer groups.

Incidence of Subprime Conventional Loans



Source: *Inside Mortgage Finance, Sept. 8, 2006*

Subprime lending became more prevalent as the rapid rise in home price appreciation grew after 2000. Between 2001 and the first half of 2006, the share of conventional loans that were subprime mortgages nearly quadrupled from 5.4 percent of mortgages to 20.2 percent of mortgages in the first half of 2006.[2] Subprime ARM originations grew rapidly over the past half decade. Subprime ARM origination rose from $114.4 billion in 2000 to $213.7 billion in 2006 – an 86.8 percent increase.[3]

As recently as a few years ago, mortgages with non-traditional features were not commonly offered to borrowers with subprime creditworthiness. At the beginning of 2004, virtually no subprime borrowers received interest only mortgages but by July of 2006 almost 20 percent of subprime borrowers received interest only loans.[4] Simultaneous seconds also were a growing share of the subprime market. Subprime 2/28 hybrid-ARMs originated since 2005 were offered with a steep discounted teaser interest rate that will sharply rise by several hundred basis points for monthly payment increases between $300 and $500 – even if interest rate indexes remain flat.[5]

Particularly in recent years, lenders qualified more and more subprime borrowers for mortgages with layered risk characteristics including very low teaser-rates, low-documentation of income, and high loan-to-value ratios.[6] Additionally, low-documentation subprime lending grew. In 2002, the low-documentation lending made up 25 percent of subprime lending but it grew by 80 percent to 40 percent of the subprime lending in 2005.[7] In 2006, 50 percent of subprime loans were written to borrowers with

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[2] Office of the Comptroller of the Currency, Response to Congressional Data Request from September 20, 2006 Hearing on Nontraditional Mortgage Products; data source, *Inside Mortgage Finance*, September 8, 2006.

[3] Orenbuch, Moshe and Kerry Hueston, Credit Suisse, "2007 Industry Outlook: Expect Some Bumps Along the Way," January 4, 2007 at 8.

[4] Walsh, Erin k., Wachovia Capital Markets, LLC, "Effects of Interagency Guidance on Home Equity ABS," October 30, 2006 at 2.

[5] FitchRatings, "2007 Global Structured Finance Outlook: Economic and Sector by Sector Analysis," December 11, 2006 at 21.

[6] England, Robert Stowe, "The Rise of the Private Label," *Mortgage Banking*, October 2006.

[7] Federal Deposit Insurance Corporation, "Breaking New Ground in U.S. Mortgage Lending," *FDIC Outlook*, Summer 2006 at 24.

low- or no-documentation of borrower income.[8] In 1999, almost no subprime borrowers used simultaneous second lien mortgages (thus enabling borrowers to purchase homes with little or no down payment), but by 2006 roughly a third of subprime borrowers also took out simultaneous second mortgages.[9]

b) Consumers Do Not Understand the Risk Associated with Risky Mortgage Products

CFA is concerned that many borrowers using mortgage products with built in payment shocks are not fully aware of the financial implications and potential hazards these loans entail. It is easy to understand why. Consumers today face a bewildering array of mortgage products that are marketed and promoted under a range of product names. While the number of products exploded, there appears to be too little understanding by borrowers about the key features in today's mortgages and how to compare or even understand the differences between these products. These problems are most severe for subprime loans which are often "push" marketed to borrowers who may not even be shopping for mortgage credit.

A 2004 Consumer Federation of America survey found that most consumers cannot calculate the payment change for an adjustable rate mortgage.[10] According to the survey, all respondents underestimated the annual increase in the cost of monthly mortgage payments if the interest rate rises from 6 percent to 8 percent by approximately 30 percent. Younger, poorer, and less formally educated respondents underestimated by as much as 50 percent.

The results of a recent Federal Reserve survey of ARM borrowers provides further indication that many borrowers are unfamiliar with even the basic terms of their mortgages. The survey found that 35 percent of them did not know the maximum increase that their interest rate can rise at one time, 44 percent were unsure of the maximum rate they can be charged, and 17 percent did not know the frequency with which their rate could change.[11]

Public Opinion Strategies, a nationally known polling organization, last year convened a focus group comprised of recent non-traditional mortgage borrowers. It also found that when consumers are shown the rate sheet with the various mortgage options they are surprised by the magnitude of the payment shock. Although upper-income focus group participants are less surprised, lower-income participants described the payment shock on the rate sheet as "shocking" and they were largely unaware of the size of the payment

[8] Miller, Derek, Mia Koo and Grant Bailey, FitchRatings, "U.S. Subprime RMBS in Structured Finance CDOs," August 21, 2006 at 4.
[9] Orenbuch, Moshe and Kerry Hueston, Credit Suisse, "2007 Industry Outlook: Expect Some Bumps Along the Way," January 4, 2007 at 8.
[10] CFA, "Lower-Income and Minority Consumers More Likely to Prefer and Underestimate the Risks of Adjustable Rate Mortgages," press release, July 26, 2004.
[11] Bucks, Brian and Karen Pence, Federal Reserve Board of Governors, "Do Homeowners Know Their House Values and Mortgage Terms?" January 2006 at 19.

shock.[12] These lower-income consumers were also less informed about the payment increases and debt risks of non-traditional mortgages, with some noting the "wish they had known more." The entire lower-income segment in one of the studied cities said that the higher payments after the mortgage recast would create a financial hardship for their families, and three quarters of them were concerned about their ability to make the monthly mortgage payments when the payments increased after the loan recast.

It is likely that this lack of knowledge has helped encourage borrowers to take out loans based on their initial repayment schedule without appreciating the possible risk of rising interest rates and increased monthly costs.[13] The lack of consumer understanding, especially among financially unsophisticated consumers, could set borrowers up to fail. Borrowers that do not fully appreciate the extent to which their notes will be recast or interest rates re-adjust will be ill-prepared to face the likely payment shock and could face losing their homes and their financial well being.

c) Concerns about Weaker Underwriting Standards and the Creditworthiness of Non-Traditional Mortgages

A basic premise in the mortgage lending industry has always been that adequate underwriting is necessary to protect the lender from loss. Indeed, evaluating the borrower's ability to repay the loan has historically been the basis for assurance against loss to the lender. Evaluation of the borrower's ability to repay the loan provides protections for both the lender and the borrower. It assures the borrower that someone schooled in the business of lending has determined that the borrower can afford to repay the loan. This underwriting process is essential for the borrower, who generally does not have the expertise to assess this question. However, in recent years the subprime mortgage industry has developed mechanisms to avoid the consequences of bad underwriting and still make substantial profits from mortgage lending. Neither the lenders nor the investors bear the risks that arise from the lack of underwriting or poor underwriting, as practical matter.[14] The industry and investors have developed a myriad of ways to protect themselves from themselves. The real risk of loss due to lender misconduct is now borne almost exclusively by the homeowner.

Risk to consumers is vastly different from risk to industry. Virtually all business risk can be protected against by a mortgage lender: more interest or fees can be charged on the loans, the servicing can be conducted in a more careful, and expensive, way, insurance against loss can be purchased, securitized pools of mortgage loans can be overcapitalized. It is all a matter of numbers and actuarial acumen to the lending industry. However, to consumers, some risks cannot be measured simply in dollars. The risk of losing one's home is a risk that most people do not want to gamble upon. It is not a risk that this

[12] *See* Fishbein and Woodall, CFA, "Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders," May 2006 at 21-21.
[13] Fahey, J. Noel, Fannie Mae, "The Pluses and Minuses of Adjustable-Rate Mortgages," *Fannie Mae Papers*, Vol. iii, Iss. 4, December 2004 at 2.
[14] *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending* (working paper 2006), available at www.ssrn.com (hereafter "Engel & McCoy").

nation's policies should foster. Yet, by allowing highly risky mortgages to be routinely made—mortgages which are known to have a very high chance of foreclosure—that is exactly what current mortgage policy does. Current policy permits mortgage products on the market that are known to lead to foreclosure for a substantial number of borrowers. While the lenders can protect themselves from the costs associated with those risks, consumers cannot reasonably do so.

The subprime mortgage industry has a business model of making loans that have a 20 percent chance of going into foreclosure within the first five years after origination, and a 60 percent chance of being refinanced.[15] Researchers have consistently marveled at the prevalence of refinancing of subprime mortgage loans, even when there are prepayment penalties present.[16] Despite the costs to the homeowners of these refinances, the lenders use this tool to transform a non-performing loan into a performing one.[17] These forced refinances are one way that the subprime mortgage industry ensures itself against loss: so long as there is sufficient equity in the home, regardless of the homeowner's ability to make the payments, there is unlikely to be a loss to the investor. Rather, because of the nature of the security – the family home – the debtor will go to great lengths to avoid that loss and will refinance, if at all possible.

The current structure of the regulatory environment for mortgage lending is based on the premise that efficient financial markets, with sufficient disclosures, and open access to choices, will produce equitable and appropriate products for consumers. Yet, as we have demonstrated, this is clearly not the case in the non-traditional and subprime mortgage market. Instead, the conversation continues to be about appropriately managing risk, *i.e.,* losses to the industry and investors, not losses to homeowners.

A recent article illustrates how the process of securitizing home mortgage loans facilitates the lack of underwriting – and thus the prevalence of predatory mortgages.[18] As the authors point out: "Wall Street firms securitize subprime home loans without determining if loan pools contain predatory loans."[19] This is the case because:

> [i]nvestment banks employ a variety of techniques, primarily structured finance and deal provisions, to shield investors from

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[15] *See* 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*, Center for Community Capitalism, Kenan Institute for Private Enterprise, University of North Carolina at Chapel Hill, January 25, 2005. http://www.kenan-flagler.unc.edu/assets/documents/foreclosurepaper.pdf. Tables 7 and 8. Each table shows that five years after a subprime loan with various characteristics typical in subprime mortgage loans (adjustable rates, prepayment penalty, balloon term), that loan would have over a 20 percent chance of being in foreclosure at some time in this five years, and a 60 percent chance of being refinanced in this five year period. Only approximately 19 percent of subprime loans were still in active five years after origination.
[16] *Id.* at Executive Summary.
[17] Vikas Bajaj, *Mortgages Grow Riskier and Investors are Attracted*, New York Times, *Sept. 6, 2006 at C1* (investors are increasing exposure in mortgage backed securities despite rising default rates and serious concerns by regulators about faulty underwriting in non-traditional mortgages).
[18] Engel & McCoy, *supra* note 16.
[19] *Id.* at 3.

> virtually all of the credit and litigation risk associated with predatory loans. Market and legal forces provide additional protections to investors.[20]

The mortgage industry protects itself from anticipated defaults and foreclosures by charging everyone a higher price, by securitizing loans in pools with less risky loans, and by adding credit enhancements.[21] That is fine as a business model for those in the mortgage industry. However, it is bad policy for this nation because it fails to account for the externality costs of the loss of homeownership and to communities into equation. The losses to the homeowner, the family, and the community from forced equity stripping refinancings and foreclosures are simply devastating.

2) New Federal Banking Agency Guidance is Helpful, but Additional Actions are Needed

Federal banking regulators in the past six months have taken two important steps to address concerns about high risk mortgage products. First, last October they issued in final form interagency guidance concerning certain non-traditional mortgage products that feature deferred monthly payments: interest only and payment option, negative amortizing mortgages. Second, federally banking regulators this past month issued proposed interagency guidance aimed more directly at subprime loan products with hybrid ARM features.

From the consumer's standpoint the most notable aspects of the October Non-Traditional Mortgage Guidance (October Guidance) is that it directs financial institutions to qualify borrowers at "the fully indexed rate (i.e., the rate in effect after the initial introductory rate expires) assuming a fully amortizing payment including potential negative amortization." In other words, borrowers should have the capacity to repay the full amount of the loan. Lenders also are instructed to consider the effect of substantial payment increase on the borrower's repayment capacity, and the importance of verifying a borrower's income. The Guidance also discourages lenders from using "collateral dependent" loans, which increase prospects for borrowers having to sell or refinance their properties once amortization begins. Regarding better consumer information, through this document federal banking regulators established an expectation for financial institutions they supervise to provide borrowers with disclosures about the relative benefits and risks of these products that are short, concise and timely. Model disclosures were offered for public comment as well, but have yet to be finalized.

CFA strongly supported prompt issuance of this regulatory policy. At the same time, we and others also pointed to its limitations. For one thing, as policy by federal regulators does not directly cover the many non-bank mortgage lenders that make the majority of mortgages. Thus we were pleased that the Conference of State Banking Supervisors

[20] *Id.* at 3-4. It is pointed out later in the article that lenders are essentially indifferent to the deceit of mortgage brokers about default risks because they can shift the risk of loss to the secondary market. *Id*. ata 15 n. 52.
[21] *Id.* at 23-29.

(CSBS) and the American Association of Residential Mortgage Regulators (AARMR) immediately acted to develop parallel guidance for state regulators. We understand that to date 30 states have adopted the parallel guidance and others are well into the process. But, unfortunately, these include key states, such as California and New York, which means that there still are market segments not covered by the September Guidance. Uneven enforcement of the state standards could be a problem going forward.

Comments made by CFA and others noted additional limitations as well, such as the lack of consumer remedies and the fact that it does directly cover subprime loan activity (except if the subprime loans contained interest only or option payment features). We joined with many other consumer, community and civil rights groups in writing to the regulators and members of Congress to call for action on this subject.

Similarly, we are pleased that additional banking agency guidance for subprime loan products eventually was issued to address adequate underwriting of subprime loans with hybrid features. We believe it will help to improve underwriting of subprime and help to ensure that these loans are made only to those for whom they are affordable.

We commend, in particular, the leadership of FDIC Chair Sheila Bair and other FDIC board members, who in conjunction with other federal regulators worked so diligently to secure interagency agreement on this policy. We also commend the Congressional leaders, such as Chairmen Frank and Maloney, Chairman Dodd along with other members of his Committee members and to the Conference of Bank Supervisors who wrote to voice strong support for the need for this supplemental guidance. However, as with September Guidance, the subprime regulatory policy is highly dependent upon the cooperation of state regulators for it to have the desired impact. Their participation in adopting parallel guidance is particularly crucial for subprime lending, since the lenders and mortgage brokers they supervise and license represent the majority of these originations. Unfortunately, because of the nature of this regulatory process full implementation of this policy will take many months to achieve. Consequently, consumers in many states will continue to be at risk of receiving loosely underwriting hybrid ARM products from lenders until each state acts.

a) Federal Reserve Board Should Act to Use Statutory Authority to Ban Unfair and Deceptive Practices

There is another invaluable step the Federal Reserve Board can take to ensure a level playing field for all loan originators and to improve upon the limited consumer protections at the federal level. This would be to utilize its authority under the Home Ownership and Equity Protection Act (HOEPA) to prohibit unfair and deceptive mortgage lending practices. See Sec. 1639 (l) (2). Congress provided such authority for the Federal Reserve to use this authority with respect to all mortgage loans, not only loans covered under the HOEPA statute (closed end and refinance transactions).

b) *Government Sponsored Housing Enterprises Regulators Should Act to Implement Interagency Subprime Loan Statement*

CFA was pleased that the Office of Federal Housing Enterprise Oversight, the financial oversight agency for Fannie Mae and Freddie Mac, acted quickly to apply the Non-Traditional Mortgage Guidance to both housing GSEs. We would hope that recent adverse developments will encourage OFHEO again to apply this latest guidance to both of the GSEs.

Both GSEs' have been active in purchasing significant shares of securities backed by hybrid adjustable rate mortgages. We commend Freddie Mac's recent announcement that later this year it will discontinue investments in these loans. We hope that Fannie Mae will follow this course.

In the meantime, it should be noted that both GSEs have been receiving credit for these investments toward achievement of their statutorily mandated affordable housing goals. Given the poor performance of these mortgages and the prospects for high foreclosure rates we believe such activity does not warrant goals credit. The U.S. Department of Housing and Urban Development, which serves as the mission oversight regulator for the two GSEs, has sufficient regulatory authority to adopt rules that would disallow the GSEs' from receiving goals credit for mortgages whose underwriting has come under federal banking regulator scrutiny. We urge HUD to engage in the necessary rulemaking process to achieve these ends.

3) Conclusion: New Consumer Protections Are Needed

CFA believes that more has to be done to ensure that consumers are adequately aware of the financial risks associated with the complex and potentially exploding payment products being offered in the mortgage market. Yet the plain fact is that these products simply may not be appropriate for all borrowers who receive them. Thus, we offer these recommendations:

First, we believe that consumers must receive timely, clear, and balanced loan disclosures to help them make wise choices. Loan disclosures mandated under the Truth in Lending Act (and implemented by Regulation Z) should be revised and made more specific and more comprehensive. Borrowers should be provided with information about the maximum payment permitted under the contract. Yet improved disclosures are only a piece of the puzzle and, in and of them, are unlikely to be sufficient for many borrowers.

Nor do we believe that enhanced financial literacy alone is an adequate answer – the system is too complex and the bargaining power too diverse. Further compounding the problem is that many borrowers over-rely on loan originators to judge mortgage products for them even though mortgage brokers and lenders typically are not obligated to provide borrowers with the best loan. Industry best practices also are not an adequate answer. To the extent that some best practices can be agreed to, they are not enforceable by consumers and regulators cannot examine for them since they are not binding. Rogue lenders can simply ignore them.[22] Regulation plays the important role of creating a level playing field for consumers and responsible lenders which does not countenance rogue players.

Second, tweaking the few federal laws that we have on the books that govern a small piece of the mortgage market – like the Home Ownership and Equity Protection Act (HOEPA) – is also not a complete answer. The mortgage marketplace has grown and developed in the 14 years since HOEPA was passed. The problems have become much worse. We need a more wholesale and comprehensive approach to protecting consumers seeking mortgage credit.

I. To maintain homeownership and to maintain the strength of home equity as a primary savings tool, the mortgage industry must be required to underwrite subprime mortgage loans to ensure that the loan is an appropriate loan for this household. To accomplish this, we need strong but flexible affirmative standards to apply to all mortgage loans. Congress should adopt a duty of good faith and fair dealing applicable to the non-traditional, hybrid adjustable rate and subprime market.[23] This duty would:

A) Require all originators to provide a loan which is suitable for the borrower's purpose based upon:

1) the borrower's circumstances, including the amount of other debt, the reliability of income, the expectations of changes in income borrower's age and plans and the number of dependents;

2) the borrower's objectives in obtaining the loan, such as the desire to lower payments, to pay off other debt, to reduce remaining term of loan, to reduce interest rate and to pay off loan early and to maximize home equity savings;

3) The borrower's ability to repay the loan, including the available income in the household, and the residual income after all debt is paid,

B) Require all lenders to consider the maximum payments possibly due under the loan, all of the borrower's reasonably anticipated expenses, and the borrower's actual residual income when determining the borrower's ability to repay the loan.

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[22] Just one example of a set of the industry best practices which have been resoundingly ignored are those entered into by Ameriquest Mortgage Corp., which is the subject of a multi-district litigation proceeding in the Northern District federal court in Illinois. *See, e.g.* In re Ameriquest Mortgage Co., 2006 WL 1525661 (N.D.Ill.) May 30, 2006).

[23] A suggested definition of a subprime or "covered home loan" is provided in Section II of these comments.

C) Prohibit steering borrowers into costlier loans than the borrower's qualification would require.

II. All players involved in the mortgage loan must be part of the solution – just as they are now part of the problem – and there must be full assignee liability applied to mortgage loans. The industry and the secondary market all argue strenuously against assignee liability of any sort, citing, among other things, a series of terrible events that will befall the mortgage industry if full assignee liability is applied.[24] The best answer to all of these concerns is to look at what happened after 1975 when the Federal Trade Commission passed the *Preservation of Consumers Claims and Defenses Rule*.[25] That rule applies full liability in most circumstances to assignees of loans used to purchase goods and services. The automobile dealers and other sellers of goods, among others, argued that if the rule passed that the cost of credit would increase, credit would be more difficult to obtain, retail merchants would be hurt, financial institutions would stop purchasing consumer loans altogether, businesses would suffer, and many would be forced out of business altogether.[26] The finance companies and the banks argued that they did not want the responsibility of policing sellers and that sellers would not survive with the additional red tape, many consumers would stop paying on the loans without cause, and that the rule would interfere with free competition.[27] However, there are absolutely no indications that the passage of this FTC rule has had any impact whatsoever on the availability of or cost of credit. Indeed, it appears that credit availability has continued to expand since the passage of this rule.[28]

III. Congress should enact a duty of good faith and fair dealing in the making of appraisals to support home loans, requiring appraiser's bonds, and the prohibition of communication to the appraiser about the desired appraised value, and a procedure to rewrite the loan amount if a retrospective appraisal shows the original appraisal was inflated.

IV. Congress should establish a requirement of good faith and fair dealing in loan servicing, providing, among other things –

- Limits on fees and charges that can be assessed a homeowner after loan closing;
- Strict protections against the use of forced-placed insurance;

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[24] This "sky is falling" list includes – a dramatic decrease in the availability of credit, particularly effecting minorities; ruinous effects on small businesses; unfair burden on the secondary market to police loans as the process is so routinized and involves so many loans at any one time, that a careful review of each loan would be near impossible and would dramatically increase the cost of credit.

[25] 16 C.F.R. § 433, 40 Fed Reg. 53506 (Nov. 18, 1975).

[26] 40 Fed Reg. 53506, 53517 (Nov. 18, 1975).

[27] *Id* at 53518.

[28] In 1970, the total non-revolving credit in the US was approximately $124 billion; growth continued steadily through the 1970s and by December 1980, the total non-revolving credit in the US was approximately $297 billion. This growth continued notwithstanding the announcement and final promulgation of the holder rule. Source: Federal Reserve Statistical Release G.19 1970 through 1980.

- A comprehensive right to cure defaults – to avoid foreclosures;
- The requirement that alternatives to default ("work-out options") be evaluated before a foreclosure can be initiated.

V. Congress should establish a Home Preservation Loan Fund to be implemented by state housing finance agencies, which would provide money to homeowners for whom the payment of the mortgage arrearage would avoid a foreclosure, but who have the wherewithal to maintain their mortgage payments once the mortgage arrearage is paid. The funds for the payment of these arrearages would operate as "silent seconds," only required to be repaid once the first mortgage is paid off.

Borrowers with risky adjustable rate mortgages and nontraditional loans that will face steep payment increases over the coming year combined with the cooling housing market threaten to create a perfect storm that could significantly increase foreclosure rates over the next few years. The costs for this fall-out will be borne not just by homeowners, lenders, and investors but also by the communities where these loans are concentrated. Concentrated foreclosures can erode property values and put additional pressure on nearby homeowners who can see their home equity dissolve before their eyes leading to a cascade of neighborhood foreclosures. Policymakers at every level of government, the mortgage industry, and consumer and housing organizations all have a common stake in seeking workable solutions to mitigate this growing problem. The actions taken by these parties in the months ahead will determine much about whether homeownership continues to be a path for wealth building and financial stability for many borrowers.

We would be delighted to work with this Committee to frame solutions to help address these concerns.