Statement of the Housing Policy Council
Of The Financial Services Roundtable

Before the
Subcommittee on Financial Institutions and Consumer Credit
and the
Subcommittee on Housing and Community Opportunity

On

Promoting Homeownership by Ensuring Liquidity in the
Subprime Mortgage Market

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Mr. Chairmen and Ranking Members of the Subcommittees on Housing and Community Development and on Financial Institutions and Consumer Credit, the Housing Policy Council of The Financial Services Roundtable is pleased to submit testimony to the Subcommittees on the topic of “Promoting Home Ownership by Ensuring Liquidity in the Subprime Mortgage Market.”

The Housing Policy Council is made up of seventeen of the largest mortgage finance companies in the nation. The members of the Roundtable and the Housing Policy Council originate over 65 percent of the residential mortgages in the United States. Our members strongly support the goal of homeownership for all Americans and help millions of consumers meet that goal every year.

The Housing Policy Council strongly supports the enactment of a uniform national standard to prevent predatory lending and our members appreciate the leadership of Chairmen Ney and Bachus and the members of the Subcommittees on this issue. We are pleased the subcommittees are focusing on the secondary market, liquidity, the importance of limiting assignee liability, and whether or not assignees of nonprime loans should be held liable for abusive actions engaged in by the original lenders. The Council believes that in certain circumstances they should, but it would be a grave mistake to make assignees responsible for the acts of persons over which they have no control and whose acts they cannot detect.

Nonprime Lending – A Major Success Story

The Housing Policy Council supports the expansion of credit to more Americans. It is a positive development that the issues you are addressing today are not the issues we all faced a decade or more ago. At that time, the focus of the debate was on the need to expand the availability of credit. The concern among policy makers was whether lenders were resisting making credit available to those who did not have perfect credit. There was widespread concern about the lack of credit available to many Americans.

Thanks to lenders' efforts, technology, and support from the secondary market the debate has shifted. Credit is widely available to people of all economic status. Today the policy concern is about an overabundance of credit, which some believe is being made available to individuals who should not receive it. The focus of today's debate actually shows that great progress has been made. It is a sign that the effort to extend credit to nonprime borrowers has been a success story. More borrowers than ever before have the opportunity to obtain and make use of credit. It is the goal of those of us in the industry to continue this success story while trying to eliminate the problems that have come with the successful effort to give more Americans access to credit.

How to Continue That Success

The Housing Policy Council believes that a national law covering nonprime lending, including a clear national standard on assignee liability, would contribute to the ability of its members to continue to extend good credit to more borrowers. While many of our members are currently operating under a wide variety of state laws, the growing proliferation of diverse state and local statutes is causing serious financial and operational problems and has caused some of our members to drastically reduce or shut down their operations altogether in some jurisdictions. Even nationally chartered institutions, that may not be subject to some of the state laws, face reputation and litigation risk. Borrowers and lenders would be best served by Congress reaching a consensus and developing a workable national law just as it did with the reauthorization of the Fair Credit Reporting Act.

In the absence of a national law, lenders face growing problems: (1) a number of states, and even cities and counties, pass widely different legislation that causes a variety of administrative and legal problems. What is permitted in some locales is not in others, sometimes even within the same state; (2) states and subdivisions begin competing to devise new restrictions; (3) because of the lack of uniformity and great variety of differences between jurisdictions the chances of honest mistakes are compounded and the possibility of litigation is magnified; (4) litigation adversely impacts the reputations of lenders, and (5) lenders decide that making loans in states and municipalities with broad and vague statutes is no longer worth the risk to their reputations, and assignees decide that buying or lending against these loans is also not worth the risk for them. The end result is actually less credit for borrowers.

Investment in companies and industries varies over time as the market constantly revises its determination of which investments produce the best risk returns. While secondary market investors have helped fund the expansion of credit to those who a decade or so ago were unable to get credit, that backing is not inevitable. In recent years, non-prime lending has moved into the mainstream and is being offered by all lenders. However, the effect of many of these new state and local laws will be to reduce the availability of credit in many areas. The first to exit will be the mainstream lenders with good reputations who have entered into nonprime lending in the past few years. Once the market sees that the risks are excessive, capital will go elsewhere.

The Role of the Secondary Market

An integral part of the supply of capital to the nonprime lending market is the breadth and depth of our secondary market. Originators of loans may keep or sell them in the secondary market. If they keep the loans on their own books, they must have capital to support those investments. However, if they sell those loans, they need less capital to support the originations, and will have additional capital available to make more loans.

A trademark of the U.S. capital markets is their innovation. By creating pools of loans and securitizing them, providing credit enhancements where demanded by the market place, and distributing those securities to individual and institutional investors through an active network of securities brokers and dealers, we have built the capacity within the investor ranks to support the dramatic expansion of our housing market. It is no surprise that the expansion of the nonprime lending market in the mid-1990s took place simultaneously with the expansion of the securitization of those loans by the secondary market.

Your subcommittees, therefore, are correct in considering the role of the secondary markets in nonprime lending, understanding how determinations are made which effect investors' willingness to invest in these securities, rating agencies' willingness to rate or to reach a sufficiently good rating, the willingness of lenders to sell their loans into the secondary market, and the willingness of assignees to purchase or lend against these loans.

It is important to understand that the market is comprised of different players, each intent upon doing its job correctly. Lenders in the primary market advance the funds in the first place and legitimately expect to be repaid. Similarly, investors in those loans such as mutual funds, pension funds and insurance companies expect their funds to be repaid and earn a return. Rating agencies help investors determine the risks they will assume with the securities created from the loans. The distribution network which sells the securities must continue to satisfy their customer's expectations. The most critical factor underlying this process is the ability to reasonably measure risks and accurately predict the performance of the loan pools. Risk that is measurable may be served by the capital markets, albeit at a higher cost. Risk that is unpredictable will not.

How does the secondary market work?

The secondary market is based upon an assignment of loans from originators to third parties. If loans are held in portfolio and not assigned, there is no secondary market. However, most are assigned and questions about the liability of assignees go to the heart of the operation of the secondary market.

Whether assigned or held in portfolio, loans undergo a process of due diligence designed to minimize legal, financial, and reputation risk associated with the purchase of the loans.

Loans are seldom, if ever, purchased singularly, but instead are purchased in pools. The assignee diligently reviews the loans to ensure they are creditworthy and in compliance with any applicable laws. The first line of diligence is to ensure that the party from whom they purchased the loans is reputable and financially sound. They then review and appraise the legal and financial information related to the loans themselves, containing information such as loan amount, interest rate, and borrower's credit score. Often the purchaser will review a sample of the loan files including the loan application and settlement forms.

This due diligence review is designed to prevent purchasing loans of an inferior credit quality, that have too high a risk of defaulting, or which carry the stigma of "predatory loans," among others. HPC member companies do not want to purchase those loans.

Many of our members will not purchase or originate "high cost loans" as defined in the Home Owner's Equity Protection Act or state laws because doing so could expose them to allegations of purchasing "predatory" loans. Mortgage market participants refuse to make or purchase such loans not because the loans may not pass reasonable underwriting standards for companies, but because the existing assignee liability provisions of HOEPA are extremely broad and there is a concern that the reputation of the firm will be sullied by buying or originating HOEPA loans. In other words, HOEPA has driven a number of reputation conscious lenders out of the high cost loan market.

While due diligence is designed to determine if the purchased loans comply with applicable laws, it cannot uncover some terms, conditions or practices which are predatory. For example, due diligence generally cannot detect cases of fraud by the borrower, broker or originator. If false income amounts are inserted in an application in order to meet an income requirement and supported by phony verifications, due diligence most likely will not detect the false statement. Similarly, "flipping", or repeatedly refinancing a loan, may go undetected because loan files do not generally include information on previous refinancings.

<u>What is the effect of making assignees liable for the predatory lending practices of originators?</u>

Should assignees be required to bear the responsibility for the predatory practices of those from whom they purchase loans?

It is clear that if the liability is broad and does not provide solid, safe harbors and limits on liabilities, lenders will refrain from purchasing a broad category of loans. This is because the risk of acquiring the loan has become too great, not because each of the loans in that category may be predatory. This means that many lenders will not originate high cost loans and purchasers will not purchase them. They will not be securitized and the secondary market will not produce the liquidity that fuels additional lending in the high cost loan market.

Similarly, if credit rating agencies are unable to measure the possible costs to the purchasers of a pool of loans, they will be unable to rate them, and purchasers are loath to purchase unrated securities at any price. In those cases there will be a dramatic decrease in the secondary market such as that which occurred in Georgia and the District of Columbia when overly-broad or ill-defined nonprime lending laws were passed.

Rating agencies flounder over undefined terms such as “tangible benefit” or “reasonable net tangible benefit” because it is difficult to predict how a court might rule on a case involving such terms. If class actions can be brought against assignees, the agencies again will be unable to measure the risk to the investors.

Even when the securities can be rated, if the risk is such that very expensive enhancements, such as more insurance, additional collateral, etc., must be added, it does not mean that the loans will be originated, or investors will buy the securities. Excessive required enhancements have the same practical effect as the inability to rate securities. Investors are concerned about securities in which the comments of the rating agencies point out myriad additional risks and then require major enhancements. Investors may just buy government bonds instead, which reduces the funding for future mortgage loans.

These are not hypothetical arguments. Standard & Poors, one of the leading rating agencies, recently clarified in a Lending Alert dated May 13, 2004, that it will not rate loans governed by the Georgia Fair Lending Act as it existed prior to its March 7, 2003 amendments, the High Cost Loans defined in the New Jersey predatory and abusive lending law, or loans originated under the Los Angeles and Oakland, CA predatory and abusive lending laws if and when these laws become effective. In addition, it announced that loans made under various state laws will require additional credit enhancements to be rated, ranging to as much as 163 percent of the price of such a loan governed by the law of the state of New York. Inevitably this reflection of the risks in these laws will reduce the origination of mortgages covered by these statutes. Thousands of homebuyers will simply be unable to get loans at a manageable price.

The Housing Policy Council urges Congress to adopt a national law that provides the secondary market with a clear and well-defined set of laws under which to operate in all jurisdictions, including laws that appropriately limit the conditions under which liability is assessed against assignees. This will provide an impetus for the secondary market to continue to provide the liquidity that is vital to the continued expansion of home ownership opportunities.

Some suggested guidelines for assignee liability provisions in national non-prime lending legislation

The Housing Policy Council does not suggest that there should be no restrictions at all placed upon assignees. We believe, however, that there should be a limit on restrictions. Restrictions should not prevent the continuation of the liquidity provided by the secondary market.

- Assignees should always have access to a workable, self-executing safe harbor so that they can safely operate with the certainty that there are no undefined terms, that commercially acceptable due diligence procedures are acceptable, and that the existence of the safe harbor does not depend upon the judgment of a third party.
- Causes of action or defenses that borrowers can assert against assignees of high-cost home loans must be related specifically to violations of the law defining those loans, and particularly only to those terms of the law that the assignee could reasonably detect through commercially accepted due diligence practices, including appropriate reviews of the face of the documents.
- Actions and defenses must be limited to those that are based on actual knowledge of the assignee of the existence of the violations in the loans assigned to them, or intentional failure to use appropriate due diligence in reviewing the loans assigned.
- Any action must be limited to individual actions, not class actions.

Thank you for the opportunity to present this testimony. We would be happy to provide the Committee with suggested language on assignee liability provisions for its consideration at the appropriate time. The Housing Policy Council looks forward to working with the Financial Services Committee to enact legislation that protects consumers and enables lenders to serve them in an efficient and productive manner.